Government of the Republic of Hungary

PRE-ACCESSION ECONOMIC PROGRAMME OF HUNGARY

2003.

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CONTENTS

INTRODUCTION

1. In 2002 it became evident that the Hungarian economy had assumed a growth path characterised by a lowered rate of growth. The unfavourable trends, which were present already in 2001 and were forecasted in PEP (Pre-accession Economic Programme) 2002, became more pronounced in several areas. In 2003, economic growth has been accompanied by similar adverse phenomena, though on a smaller scale than in 2002. Despite continuous expectations, the global economic situation has not improved, which has considerably reduced the growth potentials of the Hungarian economy. The partly anti-cyclical measures taken in 2001-2002 geared towards reducing long standing disproportionalities and resulting in substantial real wage increases and higher domestic demand, had carry-over effect in 2003 of such magnitude that their smoothing will take more than one year.

2. The most significant differences between the forecast laid down in PEP 2002 and the actual trends of 2002-2003 relate to the GDP growth rate, the structure of demand, the rate of real wage increases and the internal equilibrium. This was accompanied by the deterioration of the external equilibrium in 2003. The disinflation objective has been reached; the monetary and exchange rate policy framework has not changed. The fundamental cause of the extraordinarily high general government deficit in 2002 was not so much the shortfall of revenues but the fast growth of expenditures. As another important factor, the Government, which came into office in mid-2002, could not assess accurately the magnitude of items financed in part from extra-budgetary sources (e.g. motorway construction), or which later required the assumption of debt (BKV, MÁV, sports facilities). Other related factors included the settlement of losses of the Hungarian Development Bank, which had also had quasi-fiscal functions, as well as the mitigation of unforeseen losses caused by force majeure.

3. The Government is committed to an economic policy which counterbalances the above adverse phenomena and assures the restoration of the equilibrium and the stimulation of growth. Long-term objectives include the strengthening of social and economic cohesion, modernisation, and catching-up with Europe. The attainment of those objectives requires the enhancement of the competitiveness and capital attracting capabilities of the country, the targeting of financial and price stability as well as the stimulation of the economy.

4. The primary goal of fiscal policy is to continue, and consistently pursue, the adjustment started in 2003. As a result, and assuming a recovery hopefully starting in 2004, simultaneously with the halting of the deterioration of the external equilibrium, the net borrowing of the general government will be reduced by 1 percentage point per year until 2005, the deficit falling below 3% by 2005 and to 2.5% by 2006. This means that in order to return to a sustainable growth path, the demand restricting effect of fiscal policy will be maintained in the medium term as well. The gross public debt to GDP ratio, which is already below 60%, will be reduced to 54% by 2006.

5. As the first step, the Government decided in 2003 to focus on the economical management of the expenditure side. However, the infrastructure investments to promote the catching-up process, the appearance of EU-accession related expenditures, and the maintenance of the real value of wages in the local government and public administration sectors will also necessitate higher revenues in 2004 than originally envisaged. To this end, the Government plans to narrow the range of allowances in the PIT system and to change VAT rates, which will result in a temporary increase in the tax burden, and measures will also be taken in other areas of economic policy.

6. In the field of household incomes policy, the real wage increase significantly in excess of productivity growth, as experienced recently, cannot be maintained any further in the forthcoming years. Wage growth must be based on the profitability of enterprises in the business sector, and on the reasonable management of staff levels in the public sector.

7. In the coming years, monetary policy will be governed by the goals of price stability and sustainable disinflation necessary for satisfying the inflation criterion for accession to the EMU, while maintaining the system of inflation targeting. If a credible convergence programme is put forth, the achievement of monetary policy objectives will be promoted by the central parity of ERM II as a nominal anchor.

8. The modernisation and catching-up objectives of the country require the continuation or reinforcement of structural reforms in a number of areas. The Széchenyi Enterprise Development Programme, launched at the end of 2002, will promote the modernisation and technological development of small and medium-sized enterprises and create better possibilities for undertakings to obtain credit. From among infrastructure development projects, the expansion of the high-speed road network, which would also be part of the pan-European network, is a high priority. The design of an EU-compatible railway transportation system is also in progress. The housing programme focuses on providing more efficient Government assistance to the improvement of housing conditions of families with children; furthermore, we also intend to accelerate the rental dwelling construction programme.

9. To promote the competitiveness of the economy, the better utilisation of human resources and more balanced regional development while maintaining or improving environmental conditions, the National Development Plan and the operational programmes relying on co-financing from the EU for the period of 2004-2006 have been completed. Among these, the programme implementing regional policy objectives strengthening social and economic cohesion is of outstanding importance. In the field of agricultural and rural development and support, the establishment of a support and regulatory environment satisfying post-accession requirements and the creation of the related institutional system are in progress.

10. The electricity and gas supply Acts complying with EU directives and providing for market liberalisation have entered into force. In the field of environment protection, the II. National Environment Protection programme and the Vásárhelyi Plan, setting out a state-of-the-art flood protection concept, have been completed.

11. The creation of a modern economic structure is supported by the SMART Hungary investment promotion programme, which provides assistance to expanding investments with high value added content in the manufacturing industry, improving supplier activities and the establishment of regional enterprise centres. The creation of a knowledge based economy and information society is also a basic instrument in the modernisation of the economy and society and increasing its growth rate and competitiveness; therefore education is also a priority within the Government's policies.

12. In the field of employment and social policy, the raising of employment and activity rates and assuring equal opportunities are priorities; this is underpinned by the reform of the vocational training system. The continuation of the health sector reform comprises the conceptual fine-tuning of the financing and operating systems alike. In case of the pension system, the objectives set out in PEP 2002 are still valid.

13. The review of the overall tasks and competencies of local governments, the establishment of the system of micro-regions and regions and the reconsideration of the financing of local governments will be continued. The decentralisation of public tasks can be achieved through the establishment of a regional public administration system.

14. The fight against corruption is a priority objective in the Government programme. To achieve this objective, the Government launched the so-called "glass pockets" programme, with the key goals of rendering the financial management and finances of the government transparent and controllable and to assure publicity and transparency.

15. Based on the comparison of domestic and international economic trends, the outlined economic policy objectives and the proposed measures, the macro-economic forecast for 2003-2006 envisages a GDP growth rate higher than the current rate. The growth rate of 3.5% in 2003 would gradually increase to over 4.5% by 2006. This will be accompanied by a balanced growth of household consumption and the expansion of investments and exports. Simultaneously, the modest growth of imports (at a rate more or less similar to export growth) will bring about the halting of the deterioration of the external equilibrium, while the proposed budgetary adjustments will result in an improved domestic equilibrium. Employment will expand continuously, while real wages will grow in line with productivity growth in the medium term.

1. RECENT DEVELOPMENTS

16. In 2002 the unfavourable trends, which were present already in 2001 and were forecasted in PEP 2002, became more pronounced in several areas of the Hungarian economy. It became clear that the country was on a slower growth path, while substantial structural disproportionalities emerged in a short time. Real wages increased in excess of productivity growth, the growth of consumption was higher than that of GDP, competitiveness deteriorated, and, to a large extent due to these structural disproportionalities, an outstandingly high general government deficit was generated while the current account deficit also started to climb.

17. In 2003, economic growth is accompanied by the same adverse phenomena, even if on a smaller scale than last year. Despite the shift of emphasis implemented in economic policy in the meantime and the commencement of the implementation of a new budget for 2003 focusing on priorities geared towards the improvement of the equilibrium, this trend emerged primarily for two reasons:

- the global economic situation has not improved despite continuous expectations for this to happen in the past two years, and there is considerable uncertainty;
- the partly anti-cyclical measures taken in 2001-2002 geared towards stimulating domestic demand, reducing long standing disproportionalities in the economy and resulting in substantial real wage increases, were of a magnitude that their carry-over effect in 2003 is considerably more pronounced than in other years. The smoothing of these effects will take more than one year.

Economic indicators *annual percentage change*

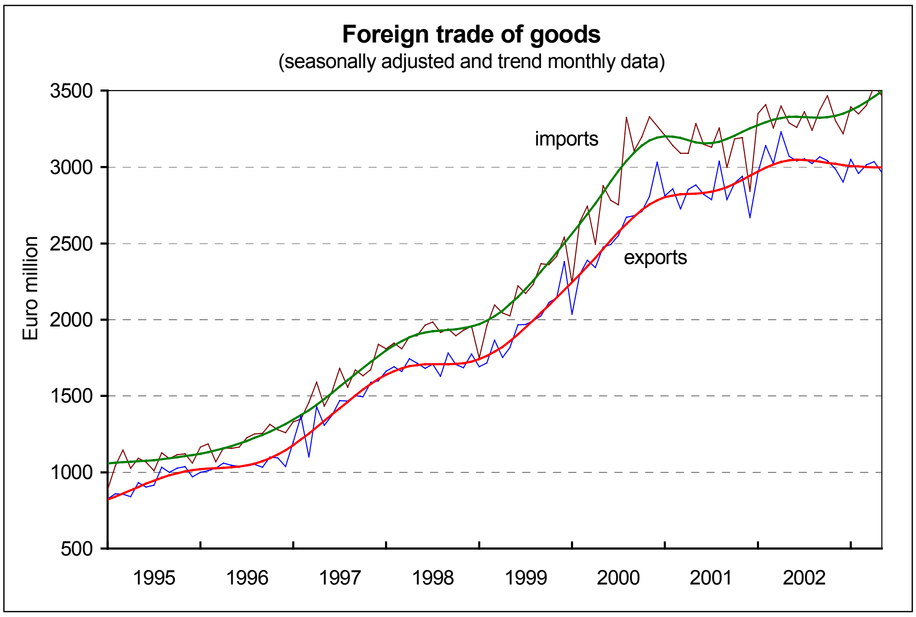
	2001/1996 (annual average)	2002		2003	
		PEP 2002	Preliminary Fact	PEP 2002	Expected
GDP	4.5	cca. 4	3.3	4-4.5	cca. 3.5
Of which: Industry	7.4	2-3	0.4	cca. 6	2-3
Agriculture	2.4	cca. 0	-8.8	5-6	cca. 0
Household consumption	4.3	cca. 8	8.8	4-5	cca. 8
Gross fixed capital formation	7.9	4-6	5.8	5-7	cca. 4
Exports	16.6	8-10	3.8	9-11	3-5
Imports	17.2	10-12	6.1	9-11	5-7
Consumer prices	12.3	cca. 5.5	5.3	cca. 5	4.8-5
Number of employed	1.1	cca.–0.5	0.1	cca. 0.5	cca. 0.5
Unemployment rate	7.1	cca. 5.5	5.8	cca. 5.5	5.8-6
Productivity	3.4	4.5-5	3.2	3.5-4	cca. 3
Gross average earnings	17.6	17-18	18.3	…	12-13
Real wages	3.8	11-12	13.6	5-6	10-12
Saving rates*	13.8	Cca. 12	9.9	…	cca. 8
General government deficit (ESA 95 methodology)**	4.4***	5.5-6	9.2	cca. 4.5	cca. 4.8
Current account deficit**	4.2	cca. 3.5	4	3-3.5	5-5.5

*/ *Total net savings (net financial savings and capital formation) of households relative to total incomes*
**/ *As percent of GDP*
***/ *Average of 1999-2001*

18. The most significant difference between the forecast laid down in PEP 2002 and the actual trends relates to the growth rate and demand components of GDP, the level of real wages, as well as the internal equilibrium for 2002 and the external equilibrium for 2003.

19. The greater depth and length of the recession of the global economy than previously forecasted has significantly reduced the growth potentials of the Hungarian economy. After the low of the first quarter of 2002 (2.9%), the quarterly growth rate of **GDP** did accelerate for a while, but in the first quarter of 2003 another low followed (2.7%). In light of this, even if some promising trends are visible, such as the growth of industrial output being higher than last year, the annual GDP growth rate for 2003 is unlikely to exceed the 3.3% of 2002. This is primarily attributable to the fact that the growth rate of exports has significantly declined due to the recession, therefore exports ceased to be the driving force of growth. The dynamic increase in consumption, which was attributable to domestic demand stimulation measures, was unable to substitute for the role of exports in growth.

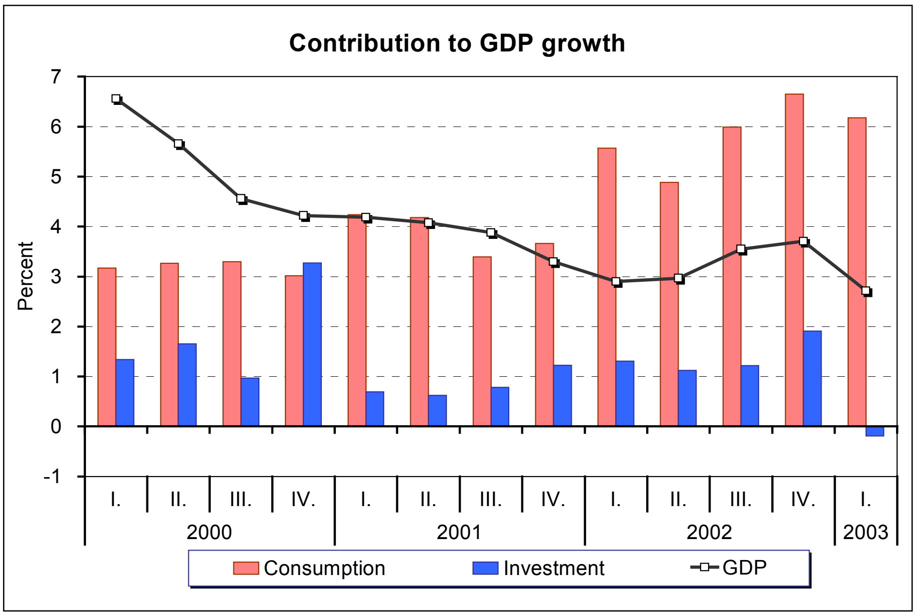
20. The rate of **export** growth has been significantly lower than envisaged in PEP 2002. The forecast therein relied on the forecasts published by international organisations, which have been modified downwards several times since then. Though an alternative scenario presuming a slower recovery was also prepared in PEP 2002, real trends proved to be even less favourable than those assumptions. The growth of exports of goods and services is not expected to be significantly greater than it was last year at 3.8%, not even after the depreciation of the Forint in mid-2003. The continued low rate is related, beyond the general effects of recession, to the move of several large firms which played a decisive role in exports to close down some of their plants or to leave Hungary, which in itself lowers the export growth rate expected for 2003 by several percentage points. The rate of **import** growth also declined in the previous period, but the decline was more moderate than that of exports. The cca. 5 percentage point growth differential in favour of imports in the first five months, which is expected to be several percentage points for the whole year as well, is also reflected in the increase of the deficit of merchandise trade. The relatively high import growth is attributable to several factors. It reflects the impact of a high growth in consumption, the low growth rate of the manufacturing industry due to narrowing export possibilities, the high import content of the relatively fast-growing machinery exports as well as the commencement of the expansion of investments in the manufacturing industry.



21. The 5.8% volume growth of **investments** in 2002 was higher than in 2001 (3.5%), but its structure has become distorted. Investments by the business sector, which are vital in respect of export capacities, declined by 3-4%, while the share of government (mainly infrastructure investments) and households (housing construction) investments increased within total investments of the national economy. In 2003, in conjunction with

the budgetary adjustment, the public element of investments may decline slightly and, in response to any potential signs of recovery, the implementation of postponed investment decisions, i.e., the increase in the share of business investments, may begin.

22. In 2002 **household consumption** increased by close to 9% due to the over 18% growth of average gross wages and the outstanding real wage growth in excess of 13%. PEP 2002 contained an alternative scenario relying on the assumption that real wage growth is higher due to significant salary increases in the public sector. However, this scenario did not reckon with such an increase of consumption and the resulting aggravation of equilibrium problems. In the first quarter of 2003, consumption growth was around 8% (over the corresponding period of the previous year), which rate is expected to remain in the whole of the year even though the rate of wage growth will subside. This growth is still considerably higher than that of GDP.



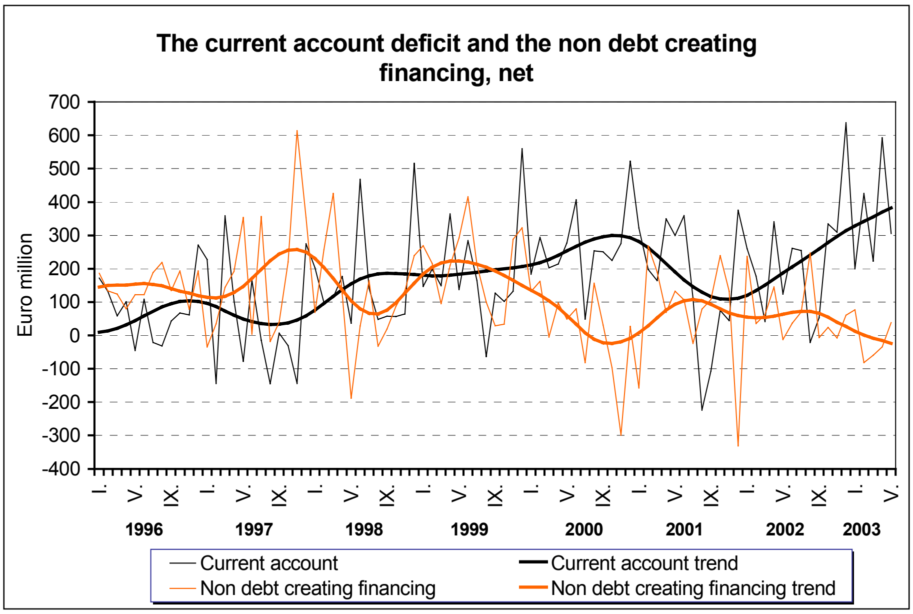
23. In 2002, the **disinflation** objective was achieved. The results of the macro-economic processes, which departed from the forecasts, affected the envisaged inflation only slightly, because the appreciation of the Forint, the inflation on the global market being more favourable than expected, and the cost reducing effect of the postponement of the increase of energy prices offset the additional expenditures resulting from the higher wages. The current international and domestic cyclical trends and the proposed economic policy measures indicate that the annual average inflation will continue the decline witnessed last year, the inflation rate being between 4.8% and 5%.

24. In the period since the submission of PEP 2002, the **monetary and exchange rate policy** framework has remained substantially unchanged. The interest rate policy of the NBH was influenced mainly by exchange rate developments. The period up to June 2003 was characterised by the decline of central bank interest rates and yields. After that date, certain economic policy measures, and their perception, changed investors' sentiments, triggering an increase in yields and the weakening of the exchange rate. The exchange rate, which was stable in 2002, started to strengthen after November, the successful conclusion of the accession negotiations. In Mid-January a speculative capital inflow started on the strong edge of the fluctuation band of the Forint. After this attack was warded off, the exchange rate stabilised due to the more active presence of the Central Bank on the foreign exchange markets. The excessive strengthening of the Forint endangered the competitiveness of the economy. Fiscal tightening, coupled with the commenced wage adjustment and the improved correspondence between real wages and productivity growth, allowed for the relaxation of monetary policy. By shifting the central

parity in agreement with the NBH, the Government intended to orientate the financial markets and the business sector in respect of the relationship between the exchange rate and economic fundamentals. Due to the inadequate efficiency of communication and the over-reaction of the market, the exchange rate weakened considerably (260-270 HUF/EUR). Only a stronger exchange rate in the range of 250-260 HUF/EUR allows for the continuation of disinflation while maintaining or improving competitiveness.

25. The **competitiveness** of the Hungarian economy, which was good in international comparison a few years ago, has gradually deteriorated in 2001-2002 and our position has shifted in an adverse direction compared to our main competitors. The inconsistencies of economic policy and economic developments lead to the appreciation of the Forint while the adjustment of wages to the declining inflation rate was delayed and slow amidst the tight labour market conditions. The resulting situation was aggravated by the general and lasting recession. The deterioration of competitiveness exerted an adverse effect on exports and on tourism, and is reflected in the current account and capital inflows. As an average of the past two years, real appreciation was 16% on a consumer price index basis and 18.4% based on the unit labour costs in the manufacturing industry. The exploitation of the growth potentials of the economy allows for no more than 1-2 per cent per annum real appreciation as the average of a longer period. In 2003, this requirement can be fulfilled in respect of the real effective exchange rate index based both on unit labour cost and on prices, and if developments are favourable, competitiveness may improve.

26. After a temporary improvement, the trend of the **current account** deficit has been deteriorating since the second half of 2001. The deterioration of the current account can be put down primarily to the decline of the surplus of the trade of services, in particular tourism, in 2002; then in 2003 the increase of the deficit of merchandise trade became increasingly dominant. The adverse trends in the financing structure, which had appeared earlier, became more pronounced this year. There has been a net outflow of non-debt generating items this year, which is attributable to the deceleration of the inflow of capital and the expansion of outward direct investments of Hungarian enterprises. However, this latter phenomenon, which has an unfavourable effect on the financing side of the current account, is welcome from the aspect of the international competitiveness of Hungarian enterprises. Unlike in previous years, inter-company loans did not contribute to the financing either. Consequently, this year the current account deficit is financed exclusively by the increase in net external debt. As opposed to the previous period, the net external debt of the business sector has not increased; therefore the growth of foreign debt comes from the increase of Forint denominated government securities purchased by non-residents.



27. In 2002, the deficit of the **general government** was extra-ordinarily high. Despite economic growth being slower than expected at the time of the budgetary planning process, the "runaway" deficit is due to the dynamic growth of expenditures rather than the failure to realise revenues. In 2002, the demand stimulation effect of the general government was close to 4% of GDP. The increase of the general government deficit to a level substantially higher than projected is attributable to a large extent to the fact that at the time of the preparation of the forecast the Government, which had not been in office for long last summer, could not assess accurately the magnitude of items financed from extra-budgetary sources (e.g. high-speed motorway construction), or which later required the assumption of debt (e.g. BKV, MÁV). The Government, having reviewed commitments, considered it necessary to free the budget from the impact of previous commitments representing a burden on subsequent years, and to make the finances of the public sector more transparent. At the end of the year, Parliament approved the amendment of the 2002 Budget Act and, within that, the assumption or relief of the debt of certain entities outside the general government (transport companies, sports facilities), as well as the settlement of losses of the Hungarian Development Bank, which had had substantial quasi-fiscal functions. Furthermore, in the second half of the year decisions that were impossible to foresee at the time of the preparation of PEP 2002 became necessary, such as the mitigation of agricultural losses caused by force majeure, and subsidies to the repayment of agricultural credits. In addition to the central budget, the deficit of the local government sub-system also turned out to be significantly higher than expected due to the steep increase of capital formation expenditures.

28. The Government decided to significantly reduce the deficit in 2003, primarily through the economical management of the expenditure side. Based on the monitoring of processes during the year and in order to attain the general government deficit level approved in the Budget Act, the Government adopted a decision for an across-the-board freezing of 2.5% of the transfer appropriations to budgetary organisations for 2003; it modified the system of interest subsidies to loans for the purchasing of housing, decided to curb the excessive growth of pharmaceutical price subsidies and to prevent the exceeding of the budget for medical and preventive services.

2. MACROECONOMIC FRAMEWORK

2.1 Objectives

29. The long-term objective of economic policy is to continue modernisation and to reach the level of development in Europe. To achieve this objective, the improvement of competitiveness and of the ability of the country to attract capital, the attainment of financial and price stability and the promotion of the cohesive forces of the economy and society are the primary requisites in the forthcoming period. These objectives can be achieved only along a sustainable growth path, and, in light of our relationship with our environment, can securely be attained only as a Member State of the European Union.

30. The unchanged economic policy objectives, however, must be reached from a different starting position. In the past 1-2 years the demand structure of GDP has changed in an adverse direction, the growth of consumption significantly exceeding that of GDP, consequently the equilibrium indicators of the economy have deteriorated substantially. This unsound structure cannot be sustained in the longer term, therefore economic policy, to maximise growth potentials, needs to implement an equilibrium adjustment to assure the reduction of the general government deficit and to keep the balance of payments under control. This is imperative if we are to stop the increase of the ratio of domestic debt and external public debt to GDP. Furthermore, as a precondition of accession to the EMU, which is now a realistic goal within the foreseeable future, the disinflation objective must also be met.

2.2 Assumptions concerning the international environment

31. As a small, open economy, Hungary is very sensitive to changes in the global economic environment. As the EU economy is predominant in our external economic relations, the Hungarian economy is subject primarily to events in that area. Therefore it is appropriate for us to design our forecasts taking into consideration the expected economic growth in the European Union. According to the projections of both the European Commission and the OECD published in the spring, the GDP of the EU will increase by cca. 2.5 % in 2004, and the volume of imports into the region by around 6%. The medium term forecast of the OECD also envisages an approx. 2.5% per annum growth for the whole of the European Union as the average for the 2005-2008 period.

32. However, based on the lessons learned in recent years and in light of the most recent developments, other factors must also be taken into account:
- The Hungarian economy is affected not only by the economies of EU Member States but other economies (such as Russia and the CEFTA countries), where relatively high growth at around 3.5-4% is projected for the years to come.
- The European economy is more dependent on the global economy, mainly that of the US, than the ratio of foreign trade would indicate. Forecasts concerning the US economy are more optimistic, reckoning with a growth of 2.5-3.5% for the period of 2004-2008.
- According to most experts, recovery in the German economy, which is very important for us, will start already in 2004.

33. However, in assessing the international environment we must keep in mind the fact that in the recent past forecasts have been continuously revised downwards, the recession of the global economy is not over yet, therefore the forecasts of international organisations should also be viewed with caution.

2.3 Macroeconomic policies

2.3.1 Fiscal policy

34. The primary goal of fiscal policy is to continue the adjustment started in the general government sector in 2003 and to reduce the deficit. Against the background of a recovery starting in 2004 in a hopefully more favourable economic environment, the deterioration of the external equilibrium of the Hungarian economy can be avoided only if the net borrowing of the general government as a percentage of GDP is reduced by at least 1 percentage point per annum in the next two years. Thus the deficit would fall below 3% of GDP already in 2005, and the adjustment would be continued in 2006, albeit on a somewhat smaller scale. The general government deficit may be 2.5% of GDP by the end of the period.

35. The deficit produced a less steep decline at the beginning of the period than envisaged in the previous PEP. The recession proved to be deeper and more lasting than it was assumed last year, and the starting position is less favourable. In view of the negative output gap, however, the cyclically adjusted balance will move approximately along the deficit course outlined in PEP 2002.

General government *percent of GDP*

	2002	2003	2004	2005	2006
Deficit	9.2	cca. 4.8	cca. 3.8	cca. 2.8	cca. 2.5
Cyclically-adjusted deficit	9.1	cca. 4.6	3-3.5	cca. 2.5	2-2.5
Deficit according to PEP 2002	5.5-6	cca. 4.5	cca. 3	cca. 2.5	

36. Fiscal policy strives to contribute, with its own instruments, to the adjustment of the growth structure, which has become adverse as a result of the excessive demand stimulation policy of the past 1-2 years, and to halting the deterioration of the external/internal equilibrium. The 2003 general government deficit target, set at 4.5% of GDP, already indicated the turnabout, i.e., the intention to restrict demand after the previous expansionary fiscal policy. The demand restricting effect will be achieved this year even taking into consideration the fact that the deficit is expected to exceed the envisaged level. (According to current projections, the deficit is likely to be around 4.8% of GDP, but there are also certain risks which warn of a potential exceeding of the target by another few tenth of a percentage point). In order to return to a sustainable growth path, the demand restricting effect of fiscal policy may be maintained in the medium term as well.

37. Even though the interest burdens on public debt as a percentage of GDP will gradually decrease, the attainment of the deficit target requires a demand restricting fiscal policy acting through the improvement of the primary balance. In this respect, the balance adjusted for the revenue losses because of the continuation of the pension reform offers a more accurate indication of the effects of fiscal policy, because the contributions paid into the fully funded private pension funds rather than into the pay-as-you-go state pension system appear as savings in another sector of the economy.

General government *percent of GDP*

	2002	**2003**	**2004**	**2005**	**2006**
Balance	-9.2	cca. -4.8	cca. -3.8	cca. –2.8	cca. -2.5
Primary balance	-5.5	cca. –1.2	-0.5-0	cca. 0.5	cca. 0.5
Pension reform revenue loss	0.5	0.7	0.8	0.9	0.9
Balance adjusted for pension reform loss	-8.7	cca. -4.1	cca. -3	cca. –1.9	cca. -1.6
Primary balance adjusted for pension reform loss	-5.0	cca. –0.5	0-0.5	1-1.5	1-1.5

38. The public debt to GDP ratio fell below 60% already in 2000, and then in 2001 it declined to around 53 percent. In 2002, the outstandingly high general government deficit caused a temporary increase in the debt ratio, but the declining trend of the rate will be resumed in the environment of the reduction of deficit and the primary balance that will show a surplus again after 2005. By 2006, public debt will be reduced again to cca. 54 % of GDP.

39. The continuation of infrastructure investments promoting economic growth and the catching-up process, the appearance of the costs of EU accession and the maintenance of the real value of wages in the budgetary sector does not allow for any notable reduction of the general government expenditure to GDP ratio in 2004. Expenditures will be around 48 percent of GDP in 2003, while in 2004 they may slightly exceed that level (of this, expenditure corresponding to less than 1 percent of GDP will be covered by Community transfers next year). The deficit can be reduced only by increasing the ratio of revenues. In 2004, revenues will come close to 44.5% of GDP. This represents a growth of slightly more than 1 percentage point over this year’s figure – more than the effect of the appearance of EU funds. In 2004, it will not be possible to implement the previously envisaged reduction of the revenue ratio. In the medium term, however, economic recovery will allow for the gradual reduction of expenditure ratios, thus the ratio of revenues to GDP may decline slightly without jeopardising the deficit target.

2.3.2 Household incomes policy

40. PEP 2002 reckoned with an overall approx. 33% increase in the real wage per wage earner in the 2001-2005 period. In contrast, wage growth is now expected to reach 34-35% already in the first three years. The significant wage increases in the public sector, the doubling of the minimum wage, the reduction of the personal income tax charge and the lowered inflation all contributed to that dynamic growth. As a result of this, the level of wages in Hungary came closer to the EU average, the wage proportions across sectors improved and the difference between the minimum wage and average wage was reduced.

41. The real wage increase significantly in excess of productivity growth cannot be maintained any further. Between 2002-2006 productivity is expected to increase by 18%, cumulatively, while real wages in the business sector are expected to grow by cca. 20% already in 2002-2003. Therefore, in the coming years, substantially slower wage growth is called for, in order to assure the necessary re-adjustment. The enterprises themselves are expected to implement only such wage hikes which contribute to improving competitiveness, and through that, the further reduction of inflation, the expansion of employment and our accession to the euro area. Accordingly, real wages in the national economy may increase only moderately in 2004-2005 and in line with productivity from 2006.

42. In the business sector, wages may increase as a function of the ability of enterprises to bear the costs and their profitability. In the budgetary sector, wage growth partly relies on the reasonable management of staff levels. The government is committed to concluding a comprehensive economic policy agreement with the social partners covering medium term wage, price, tax and employment policies.

2.3.3 Monetary and exchange rate policy

43. Hungary will become a Member State of the European Union on 1 May 2004. By the act of accession, the country also undertakes the commitment to introduce the euro following the fulfilment of the necessary criteria. The benefits of integration inherent in our EU membership can be exploited fully only after the introduction of the common currency. The benefits of the common currency are present in two very important contexts: on the one hand, the introduction of the euro will promote macro-economic stability through its effects in fending off currency crises, reducing risks and "enforcing" a consistent economic policy, and on the other hand, it creates an environment conducive to faster economic growth. Exchange rate risk will be eliminated, the risk premium and real interest rates will be reduced, transaction costs will decrease and the current account constraint will diminish. Investment opportunities and savings instruments will become more numerous and more efficient. As a result of the common currency, foreign trade will expand; the larger market will bring about greater competition and higher productivity, that is, both demand and supply will increase. Naturally, the benefits of the use of the common currency will not materialise automatically; the exploitation of the better growth potentials will require an appropriate economic policy. The high degree of integration of Hungary into Europe and the similarity of business cycles assures that Hungarian macro-economy continues to develop harmoniously after the single monetary policy is introduced. Fiscal policy will have to adapt to keep any overheating, due to lower real interest rates, within appropriate limits, and well-functioning financial supervision is imperative. The benefits of the introduction of the euro for Hungary exceed any costs that may arise from potential risks.

44. The introduction of the common currency is of outstanding importance in the development of Hungary and in its catching-up with the EU Member States. In order to realise the benefits of the adoption of the common currency, the Government decided to introduce the euro on 1 January 2008. This is a significant disciplinary force for economic

policy, demanding the reduction of the general government deficit, the increase of wages in line with productivity growth, the continuation of disinflation and, consequently, the fulfilment of the inflation criterion. The introduction of the euro, as an almost unique opportunity, represents an objective in social and political life which allows for a broad consensus and which has a significant motivating effect on the public at large. The embracement of that objective by the majority allows for the easier implementation, with less social conflicts, of reform-type and consolidation measures, which are indispensable in the interest of the development of Hungary. By a disciplined and co-ordinated economic policy and the careful definition of the ERM II entry conditions, accompanied by credible communication, unpredictable speculative trends and significant interest rate and exchange rate fluctuations can be avoided, and the interest premium will be reduced, that is, the benefits of membership in the common currency area can be realised partially already in the preparation phase.

45. In the coming years, monetary policy will continue to be governed by the sustainable reduction of inflation and the achievement of price stability and, as part of that, the fulfilment of the Maastricht inflation criterion required for accession to the EMU. The inflationary objectives of the central bank can be derived from the date of accession to the EMU (2008). The disinflation process required for the fulfilment of the inflation criterion will be based on the robust support of fiscal policy and on monetary policy maintaining the inflation targeting regime, within the framework of ERM II. If a credible convergence programme is put forth, the central parity of ERM II will orientate long-term exchange rate expectations, which serves as a nominal anchor in achieving the objectives of monetary policy. In the case of co-ordinated economic policy and anchoring of long-term inflationary and exchange rate expectations, conditions of stable exchange rate developments can be created.

46. The present exchange rate system is compatible with ERM II; therefore its key parameters (central parity, band width) need not be changed until accession to the ERM II. The Government, in concert with the central bank, has expressed its commitment to joining the ERM II, which is a precondition for accession to the euro area, as soon as possible after we become Member State of the EU. Unlike in the case of the vast majority of accession countries, this exchange rate mechanism is very similar to the Hungarian exchange rate system, which makes ERM II entry easier. Participation in ERM II has substantial benefits while it has no major risks. Its benefits include greater credibility and the fact that, as no unilateral decision can be taken in ERM II, the risk premium expected by foreign investors because the exchange rate policy decisions of a given country, in our case Hungary, are not fully predictable, will be reduced significantly.

47. When selecting the ERM II accession central parity, the most important consideration is that is should allow the real exchange rate to be around the equilibrium level in the long term, that is, the nominal exchange rate should be at a level appropriate for the real economy. An equilibrium real exchange rate exists if the internal and external equilibrium of the economy is achieved, that is, at the real exchange rate concerned, the economy grows along the potential output path, while the current account deficit moves along a sustainable path in the long term. When selecting the appropriate ERM II accession central parity, due consideration must be paid to promoting disinflation, achieving and maintaining price stability; maintaining and improving competitiveness to underpin dynamic economic growth; avoiding excessive volatility of capital flows, and promoting stability in general.

48. Before ERM II entry, the central bank will strive to ensure that the market rate converges to the credible and sustainable central parity, which promotes both competitiveness and disinflation. As long economic developments are in line with the baseline scenario - namely the growth of household demand slows down considerably and measures increasing the price level in 2004 will lead neither to the increase of inflation expectations nor to the acceleration of nominal wage growth - this exchange

rate also promotes the disinflation process. Increasing inflationary risks may necessitate of the tightening of monetary conditions. The fulfilment of the Maastricht inflation criterion in the targeted reference period does not allow that the central bank accommodates lasting deviations from the disinflation path.

2.3.4 Competitiveness

49. Adjustments in wage levels, the appreciation of the Forint and the unfavourable external economic trends have worsened the previously good competitiveness of the Hungarian economy; therefore improving competitiveness is a central issue for economic policy at present. As said above, in paragraph 41, wage growth should decelerate over the next two years.

50. The improvement of competitiveness, which will in turn promote the resumption of the export and investment driven sustainable growth path, is the objective behind the reduction of the relative weight of the general government and government measures to encourage investments and improve the country's capability to attract capital as well. In achieving these objectives, incentives to business investments, the expansion of infrastructure (transport, information technology) investments, the alleviation of regional differences and focused employment policy measures (part-time employment, propagation of distance work, improvement of the training structure, etc.) may play a major role; this is also promoted by privatisation policy and institution development to assure the efficient use of Community transfers.

2.3.5 Inflation

51. The Government strives to achieve a growth, budgetary and inflation path in line with the economic policy programme. With a view to the proposed introduction of the euro in 2008 and to the convergence criteria, a balanced budgetary policy, wage- and incomes policy will be the main pillars of reducing inflation. In line with the requirements of ERM II, monetary policy supports the disinflationary process primarily through assuring exchange rate stability and providing a long-term nominal anchor to orientate expectations.

Consumer prices *annual percentage change*

CPI	2001	2002	2003	2004	2005	2006
	Fact		Projection		Target	
Year/year	9.2	5.3	4.8-5.0	cca. 5	cca. 4	cca. 3

52. In 2002, inflation fell significantly; monetary conditions and market adaptation played a decisive role in this, but the reduction of global market prices and the prices of certain domestic products (e.g. unprocessed foodstuffs) also contributed to this development.

53. In the first half of 2003, consumer prices increased slower than projected (in June, 4.3 % over the same month of the previous year). The rate is partly due to seasonal effects. As a result of the weaker Forint exchange rate as of June, the proposed increase of regulated prices and the measures aimed at reducing the excess supply of foodstuffs, year-on-year inflation is expected to increase in the second half of the year. As an annual average, 4.8-5% inflation is to be expected in 2003.

54. In 2004, additional inflation is expected to arise from certain taxation policy measures proposed partly in connection with our EU accession and also from changes in the regulatory environment. The reduction of the net borrowing requirement of the government (local governments) and incentives for more rational utilisation of resources

justify an increase of regulated prices in excess of the average rate of inflation. As a result of all these factors, no decrease in the consumer price index is to be expected even in light of the slowdown of market driven price increases.

55. Taking into consideration other priorities of economic policy as well, in 2005-2006 the rate of inflation needs to decline by approx. 1 percentage point per annum for the disinflation target to be realised. This requires that the one-off increase of price levels in 2004 be not built into longer-term inflationary expectations. In the case of non-regulated prices, price increases will be continuously declining throughout the period as a result of the more fierce competition on the open Community market and against the background of controlled demand and wage trends.

56. Because of the productivity differential of industrial goods and services, the inflation differential between the two sectors is likely to remain substantial. In the case of industrial goods, the price trends prevailing in EU member states point to an annual price increase of 1-2% in retail trade, which effectively means price stability. In the case of services, particularly where competition on the local market is limited, price increases will be between 4-6% per annum, moving parallel with wage increases. This indicates that the Balassa-Samuelson effect is to be reckoned with in the longer term as well.

57. To achieve the EMU-accession at the proposed date of 2008, we must meet the inflation criterion, among others, in the reference period. This is expected to be a rate below 3%. This is the motive behind the scheduling of regulated price increases so that no further raise in regulated prices is necessary early in 2007.

58. The achievement of the disinflationary path is expected to be promoted by measures fostering more competition on the market. The acts and other legal regulations on the liberalisation required in the EU directives in the fields of electricity, gas supply, communications and information technology have entered, or will enter, into force. Liberalised purchasing and price conditions already offer benefits to large consumers. Gradual implementation, especially in the case of energy, is justified by the constraints on production and transportation capacities and on import capabilities as well as the lack of experience with the operation of a liberalised market. The new agricultural market regime, effective as of this year, adopts the principles of the CAP, while in 2004 further changes will occur: the prices of main agricultural products will have to be adjusted to EU requirements in their levels as well. The development of the legal and technical conditions of the liberalisation of the freight and passenger transportation market is in progress, taking into consideration the financing background of the necessary investments. The regulation and subsidisation of pharmaceutical prices will be placed on new foundations in line with EU directives.

2.4 Macroeconomic forecast 2003-2006

59. The current projections for the 2003-2006 period are different at several junctions from the macroeconomic forecast in PEP 2002. This is primarily due to the changes in the basic assumptions, which is attributable mostly to external factors. The prolonged global recession has also forced international institutions to revise their growth forecasts downwards. Every forecast on the global economic trends prepared last autumn expected recovery to start already in mid-2003. In contrast, forecasts prepared in spring 2003 expect growth to start towards the end of the year or early next year.

GDP growth rate *annual percentage change*

	Forecast, autumn 2002		Forecast, spring 2003	
	2003	2004	2003	2004
OECD forecast				
Germany	1.5	2.5	0.3	1.7
Austria	1.9	2.6	1.1	2.0
Italy	1.5	2.5	1.0	2.4
Euro-zone	1.9	2.7	1.1	2.4
EU forecast				
Germany	1.4	2.3	0.4	2.0
EU-15	2.0	2.6	1.3	2.4

60. The extremely open Hungarian economy reacts very sensitively to changes in the global economy, therefore these adverse developments have to be reckoned with, when preparing the forecasts. It must also be taken into account that, as a result of the excessive demand stimulating economic policy of recent years, the structure of the economy has changed so adversely that, without a certain degree of adjustment, the resumption of the path outlined in the PEP 2002 might become impossible, or would be delayed.

2.4.1 Baseline scenario

61. As a consequence of the economic slowdown, the unemployment rate, which had been gradually decreasing until 2001, started to climb slightly in 2002, and also in this year, and is expected to approach 6% on average in 2003. All this happened against the background of the declining **number of persons employed** in the business sector and the growth of employment in the public sector. The latter development is to a large extent related to the significant wage increase of public servants, which brought many employees, who had previously left their original professions, back to the public sector. From 2004 onwards, the business sector may become the main absorber of labour; in the next three years we reckon with an employment growth of 1-1.5% per annum in this area. On the other hand, the number of employees in the public sector will decline in 2004 on the aggregate, partly due to natural decrease, partly because of the reforms of certain areas of the public sector (health care, education) while the expansion of certain tasks relating to EU accession justifies an increase in employment in some areas.

62. In the period of 2003-2006 we expect an approximately 3-3.5 % annual improvement in **labour productivity**. The gradual expansion of employment will allow for a slight increase in the activity rate which will reach 62 % by the end of the period. These developments will create the possibility for the growth of the Hungarian economy to approach the annual 5% rate by the end of the period after the temporary fallback.

Employment *annual percentage change*

	2002	2003	2004	2005	2006
Number of employed	0.1	cca. 0.5	cca. 0	cca. 1	1 – 1.5
Labour productivity	3.2	cca. 3	3 – 3.5	3 – 3.5	cca. 3.5
Unemployment rate, %*	5.8	5.8 - 6	5.8 - 6	5.5 - 6	5.5 - 6
Activity rate, %**	59.7	cca. 60	60 - 60.5	cca. 61	61 - 62
GDP growth rate	3.3	cca. 3.5	cca. 3.5	4 - 4.5	4.5 - 5

**/ ILO methodology, annual average*
***/ Share of active population relative to that of 15-64*

63. The dynamic growth of the domestic capital stock is an important factor in maintaining fast and sustainable economic growth. The global recession had an adverse effect on the willingness and ability of the business sector to invest, thus the **investment ratio** fell from the 23.6% in 2001 by over 1 percentage point in 2002. Underlying this process, there was a highly unfavourable change in the structure of investments: government investments produced an intensive growth while business investments declined because of the self-correction due to the recession. The decline of the investment ratio will continue in 2003, but promising signs already indicate an upturn in business investments, which would improve the structure of investments. The investment ratio will start rising again after our EU accession in 2004 and by 2006 it will converge to the 25% level, typical for Cohesion Fund countries. Following the year after our accession, we reckon with EU transfers corresponding to 1-2% of GDP, thus investment growth may come close to 10 percent.

Investments *percent of GDP*

	2002	2003	2004	2005	2006
Investment ratio	cca. 22.3	cca. 22	22 – 23	23 - 24	24 - 25
Of which: business sector	cca. 12.3	cca. 12	12 - 12.5	cca. 12.5	cca. 13

64. External funding will continue to play a major role in financing investments: **EU transfers**, which will gain in importance after accession, and the inflow of **foreign direct investments**, which will resume their upward trend after the start of economic recovery. In quantifying domestic sources of funds we started from the premise that, as a result of the reduction of the employer’s social security contribution, the alignment of wage growth with profitability, the continuing productivity growth and the exchange rate having been adjusted to economic realities, the unit labour cost of enterprises may be reduced significantly in the medium term. Therefore the funds available for capital formation may increase considerably, which, coupled with the increase of external demand, facilitates the expansion of business investments. Because of the continued emphasis on incentives to housing construction and renovation, the savings of households will also play a part in financing investments.

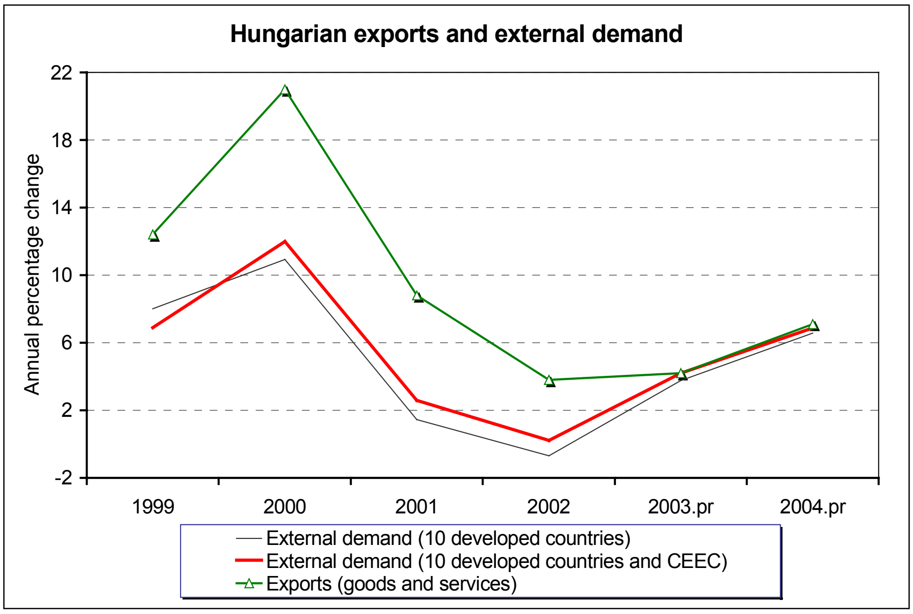
65. In 2003, as a result of carry-over effects from the previous year (non-taxation of the minimum wage, salary increases in the public sector), the growth of both **real wages** (cca. 11%) and **household consumption** (cca. 8%) is still considerably above GDP growth. In the budgetary sector the increase of the gross average wage is expected to be significantly above the average rate in the national economy despite the fact that new government measures will be implemented only in a limited circle and they will not have substantial impacts this year (second phase of the salary increase of civil servants, salary increase of judges and public prosecutors). In the business sector the expected increase of average wages (8-9%) has slowed down considerably as compared with previous years, but it still brings about greater real wage growth than it had been agreed in the interest reconciliation process. As in the previous two years, this real wage increase will be well above productivity growth, worsening the competitiveness of the economy. In the coming years much greater emphasis will have to be placed on keeping wage increases in line with productivity growth. The attainment of that harmonisation at least as an average for 2003-2004 requires that the growth of real wages in 2004 is considerably lower than this year. In order to achieve this objective, the mechanisms of interest reconciliation may also need to be reconsidered.

66. In the coming years the improvement of **competitiveness** will be a focal point of economic policy, as this is indispensable for the resumption of a sustainable and balanced growth path of the economy. This can be attained only with a strict household incomes policy and budgetary expenditure policy. This must be accompanied by a consistent **disinflation**ary policy, resulting in a rate of inflation of no more than 3% by 2006. In

2004 exogenous factors – changes in VAT rates and in regulated prices – are expected to halt the disinflationary process (indeed, if increased tax burdens arising from the changes in the VAT regime can be passed on in their entirety, inflation may even increase slightly). This effect may be offset by the narrowing of demand. In the coming years, however, the rate of inflation will again decline by approximately one percentage point per annum.

67. As a consequence of these co-ordinated policies, real wages are expected to remain close to the previous year level in 2004, and their growth in subsequent years will be more modest than that of productivity. This is imperative if the growth structure, which has been highly distorted in recent years, is to approximate the course outlined in the medium term economic programme of the government. PEP 2002 envisaged household consumption expenditures to grow by some 30%, in line with economic output, between 2001 and 2005. In the first three years consumption rose by 27% while the output of the economy increased at a lower rate than projected. It is only with restrained wage growth that we can assure that in the coming years consumption growth does not exceed GDP growth, in line with the need to increase the capital formation ratio. Within consumption, household consumption expenditure will produce faster growth, while the volume of **social benefits in-kind**, mostly financed from the general government budget, should rise at a considerably more modest rate. The structure of consumption will develop as a function of income growth and the approximation of VAT rates and relative prices to the EU.

68. According to our forecast, economic growth may be driven by exports from 2004 onwards, side by side with the strong expansion of domestic demand. The import-based **business cycle indicator** calculated using the forecast of OECD shows a strong, close to 7% recovery already in 2004, especially if we take into consideration for the potential market growth not only the developed countries but our key partners in Central Eastern Europe as well.



69. Up till 2002, the growth rate of the volume of Hungary's exports has always exceeded, even though by a declining margin (of 4-10 percentage points), that of the business cycle indicator calculated from the import demand of the key partner countries. However, based on the figures available for the period up to June, it is more likely that the delayed effect of the protracted recession will prevail for some time, therefore we

project export growth for 2003-2004 to be practically parallel with the growth rate of external demand. Other signals for caution include the fact that the approx. 20 percentage point decline in the wage cost based competitiveness of Hungarian exports in 2001-2002 also have a material impact, and that the additional export expanding effect of the import demand of trading partners in central eastern Europe is losing of importance.

70. So that the improving economic indicators exert their favourable influence, it is imperative to reverse the deteriorating trend of competitiveness, to improve the propensity of the corporate sector to invest, which are key elements in the economic policy objectives of the government. Taking this into consideration, we forecast growth of **exports** to be 6-8% in 2004. An export expansion experienced at the turn of the millennium is not expected in the coming years, but the continuation of the export-driven growth and an 8-10% growth in the export of goods and services by the end of the period are realistic objectives for the Hungarian economy.

71. In line with rapid export growth and the intensifying expansion of domestic demand, the growth of **import demand** in the economy will continue in the coming period. The development of infrastructure and the promotion of incentive programmes for business investments are indispensable for balanced economic growth. Furthermore, EU accession will also have the effect that import demand grows faster than total demand. Imports and exports are expected to increase at a more or less similar pace, thus the foreign trade deficit will continue to grow in the medium term.

GDP components *annual percentage change*

	2002	2003	2004	2005	2006
Household consumption	8.8	cca. 8	1.5 – 2	3 - 3.5	3 – 3.5
Government consumption	1.5	2.5 - 3	cca. –2	cca. 1	1 - 2
Investments	5.8	cca. 4	6 – 8	7 - 9	8 - 10
Domestic demand	*5.1*	*cca. 5.5*	*3 – 4*	*4.5 - 5*	*5 - 6*
Exports (goods and services)	3.8	3 - 5	6 – 8	7 - 9	8 - 10
Total demand	*4.5*	*cca. 5*	*cca. 5*	*6 - 7*	*cca. 7*
Imports (goods and services)	6.1	5 - 7	6 – 8	8 - 10	9 - 11
GDP	*3.3*	*cca. 3.5*	*cca. 3.5*	*4 - 4.5*	*4.5 - 5*

72. The change in the structure of growth in recent years went hand in hand with the change of the composition of **savings/investments**. As a consequence of the expansion of final consumption exceeding GDP growth, the gross savings to GDP ratio fell by 4.5 percentage points between 2000 and 2002. The deterioration of the external equilibrium could be avoided only because of the – otherwise highly unfavourable – decline in the capital formation ratio. The savings ratio will continue to decline this year. At the same time, fixed capital formation will develop more favourably, though the contribution of inventories to growth will remain negative, the slight additional decline in the capital formation ratio will not offset the drop in the savings rate, thus the net external financing requirement of the national economy will increase.

73. The objective of economic policy is to resume the sustainable growth path with a more favourable structure. The savings ratio needs to increase again, and the consumption/capital formation ratio must shift in favour of capital formation. As a result of the growth of final consumption being slower than that of GDP, the net savings to GDP ratio may increase by 4 percentage points by 2006.

Saving and capital formation ratio *percent of GDP*

	2000	2002	2003	2004	2005	2006
Final consumption	73.0	cca. 78	cca. 81	cca. 79	cca. 78	cca. 77
Gross saving	*24.6*	*cca. 20*	*cca. 17*	*cca. 19*	*cca. 20*	*cca. 21*
Capital transfers, net	0.6	0-0.5	0-0.5	0.5-1	cca. 1	cca. 1
Gross capital formation	30.9	cca. 24	cca. 22.5	cca. 24	cca. 25.5	cca. 27
Net lending(+)/Net borrowing(-)	*-5.7*	*cca.-4*	*-(5-5.5)*	*-(4.5-5)*	*-(4.5-5)*	*-(4.5-5)*

74. The growth of the capital formation ratio, in particular of business investments, will result in the increased borrowing requirement of enterprises even if their own resources also increase. At the same time, even though in the coming years the drastic drop in household savings, which occurred previously and is attributable mainly to expanding borrowing, will not continue, no significant increase is to be expected either. The change experienced in recent years in consumption and savings decisions is likely to be the result of a structural shift. Households are switching from the previous level of indebtedness, very low in international comparison, to a higher level. Economic policy may contribute to improving the households' propensity to save by providing incentives to savings. Even so, given the significantly lower level of household savings and the growing financing requirement of enterprises, the deterioration of the external equilibrium in the years to come can be avoided only if the adjustment started in 2003 in the general government continues. In the next two years the deficit will be reduced by 1 percentage point annually, which process will continue in 2006, though at a somewhat lower rate.

Net lending/ Net borrowing *percent of GD*P

	2002	2003	2004	2005	2006
Total economy	*cca.-4*	*-(5-5.5)*	*-(4.5-5)*	*-(4.5-5)*	*-(4.5-5)*
Households	cca. 2.5	cca. 1.5	cca. 1.5	cca. 1.5	cca. 1.5
Corporations	cca. 3	cca. –2	-(2-2.5)	-(3-3.5)	-(3.5-4)
General government	cca. -9.2	cca. -4.8	cca. -3.8	cca. -2.8	cca. -2.5
Current account deficit, euro billion	2.8	cca. 4	cca. 4	4–4.5	4.5-5
% of GDP	cca.4	5-5.5	cca. 5	cca. 5	cca. 5

2.4.2 Alternative scenarios

75. The extremely uncertain global economic environment in itself necessitates the development of several scenarios. This is complemented by the government measures aimed at correcting the adverse changes in the internal structure of the economy, the complex effects of which are difficult to model. Therefore a number of variants of the baseline scenario are possible, and several calculations were prepared during the drafting of the PEP and the 2004 budget.

76. The highest uncertainty, as this is the least under our control, lies in the global economic environment. The scenario assuming a **slower economic recovery** starts primarily from a less favourable trend of external demand in 2003-2004 than envisaged in the baseline scenario. In this case, export growth this year can be even lower than the level in 2002, and improvement can be expected only from the second half of 2004. In the highly export oriented Hungarian economy the lower level of exports has a strong impact on the profitability of enterprises. Because of the drop in revenues and the under-utilisation of export capacities, the investments of the business sector will increase at a

more modest rate, and the investment rate will increase only slightly over the low level expected for this year. The loss in exports and investment opportunities would reduce the import demand of the economy, therefore production driven import growth, in line with the start of the economic recovery, can be expected only from 2004. On the whole, the growth rate of the Hungarian economy will be around 3% this year and next year alike, and more marked growth is expected only after 2005.

Slower economic recovery scenario *annual percentage change*

	2003	2004	2005	2006
Household consumption	cca. 8	1.5 – 2	3 – 3.5	3 – 3.5
Investments	3 - 4	cca. 6	cca. 7	8 – 9
Domestic demand	*cca. 5.5*	*cca. 3*	*cca. 4.5*	*cca. 5*
Exports (goods and services)	2 – 4	5 - 7	6 - 8	7 – 9
Total demand	cca. 4.5	cca. 4.5	5 - 6	6 – 7
Imports (goods and services)	5 - 7	5 – 7	7 - 9	8 – 10
GDP	*cca. 3*	*cca. 3*	*3.5 - 4*	*4 - 4.5*
Current account deficit, % of GDP	cca. 5.5	5-5.5	5-5.5	5-5.5

77. In this case the lower growth results primarily from lower exports and investments. The main revenue items of the budget, which are affected mostly by wage and consumption trends, would not be effectively influenced by the lower growth rate. The HUF 150-250 billion lower level of GDP at current prices would bring about only a slight change in the deficit to GDP ratio. On the other hand, the current account deficit may exceed 5.5% of the GDP already this year, and it will not fall below 5% in the coming years either.

78. We should reckon with the economic policy risk that, should the inflation temporarily accelerate at a faster rate, **consumption growth** could be **lower** in 2004 than in the baseline scenario. According to the basic assumptions, the factors conducive to price increases would be partially offset by market competition, the scarcity of demand and tight monetary policy. However, the timing of the emergence of effects of these anti-inflationary factors is difficult to foresee, and if that process is slower than expected, the rate of inflation may be higher by cca. 1 percentage point than projected in the baseline scenario.

79. The changes in indirect taxation to come into effect at the beginning of 2004 as well as the increases of regulated prices in 2003-2004 will result in a one-off increase of price levels. If, due to less intensive competition on the product markets than assumed or smaller price elasticity of demand, those changes in direct taxation exert an asymmetrical effect on prices, the result may be perceivable inflation. As another risk factor, the effective price increases may raise inflationary expectations as well. This risk is aggravated by the fact that the price increases resulting from indirect taxation changes affect primarily regulated products with high price transparency. In contrast, higher domestic price rises caused by the weaker exchange rate and the supply-side price pressure originating from increased costs may partially be offset by the decline of demand resulting from a tight incomes policy.

80. In the more uncertain environment businesses are expected to pursue a cautious wage policy. Thus, due to the demand constraints, in 2004 the faster consumer price growth will bring about a slower consumption growth (less than 1%) than in the baseline scenario. As a result, GDP growth will slow down to below 3%. In the environment of higher inflation and more uncertain markets, and the concomitant higher real interest rates, investments will be unable to offset the decelerating impact of slower consumption growth on overall economic growth. Lower consumption and investments will reduce the import demand of the economy, bringing about significant improvement in the external equilibrium.

Lower consumption scenario *annual percentage change*

	2003	2004	2005	2006
Household consumption	cca. 8	0.5 - 1	2.5 – 3	3 – 3.5
Investments	cca. 4	cca. 5	7 - 9	8 – 10
Domestic demand	*cca. 5.5*	*cca. 2*	*cca. 4.5*	*cca. 5*
Exports (goods and services)	3 – 5	6 – 8	7 - 9	8 - 10
Total demand	cca. 5	cca. 4	cca. 6	cca. 7
Imports (goods and services)	5 - 7	5 – 7	7 - 9	9 - 11
GDP	*cca. 3.5*	*2.5 - 3*	*3.5 - 4*	*cca. 4.5*
Current account deficit, % of GDP	5 - 5.5	cca. 4.5	cca. 4.5	cca. 4.5

81. If price increases are higher next year than projected, this may also endanger the disinflation envisaged for the years after 2004, through increased inflationary expectations. In this case, economic policy must assure through a controlled incomes and fiscal policy and tight monetary policy that the rising inflationary expectations and wage demands in the forthcoming years do not endanger the disinflationary course necessary for meeting the Maastricht criteria. However, even under these assumptions, inflation may decline to 3% by 2006.

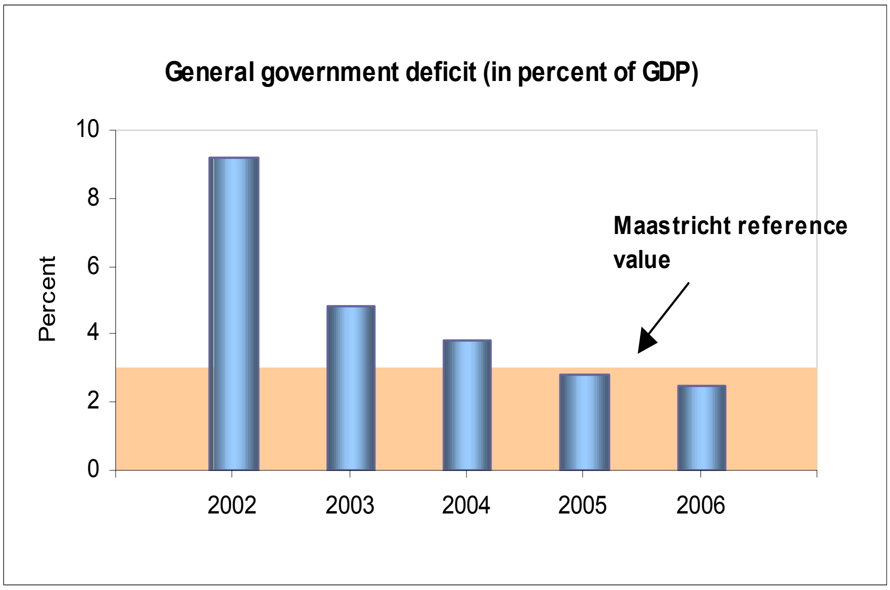
82. As a result of higher prices and slower real growth, nominal GDP would not change significantly. Despite the lower volume of consumption, consumption at current prices would not decline; indeed, VAT receipts would even be a few billion Forints higher than in the baseline scenario and there would be no shortfall in the PIT revenues either. On the expenditure side, in 2004 pension expenditures would be some 8-10 billion HUF higher than budgeted due to higher inflation, thus on the whole the budget deficit would barely change compared to the baseline scenario.

3. PUBLIC FINANCE

3.1 Medium-term fiscal framework

83. The primary objective of fiscal policy is to reduce the general government deficit, to decrease the public debt to GDP ratio and, in the medium term, to create a smaller and more efficient general government.

84. Hungary strives to join the Economic and Monetary Union at the earliest possible date. The Government and the Central Bank have set the target date at 2008, therefore preparation for EMU membership and the fulfilment of accession criteria are outstanding priorities in the coming years. The general government deficit to GDP ratio, after reaching 4.8% in 2003, will fall by 1 percentage point each year in 2004-2005. Therefore, in 2005 it will be below 3 percent of GDP already, while in 2006 it will have dropped to 2.5% of GDP.



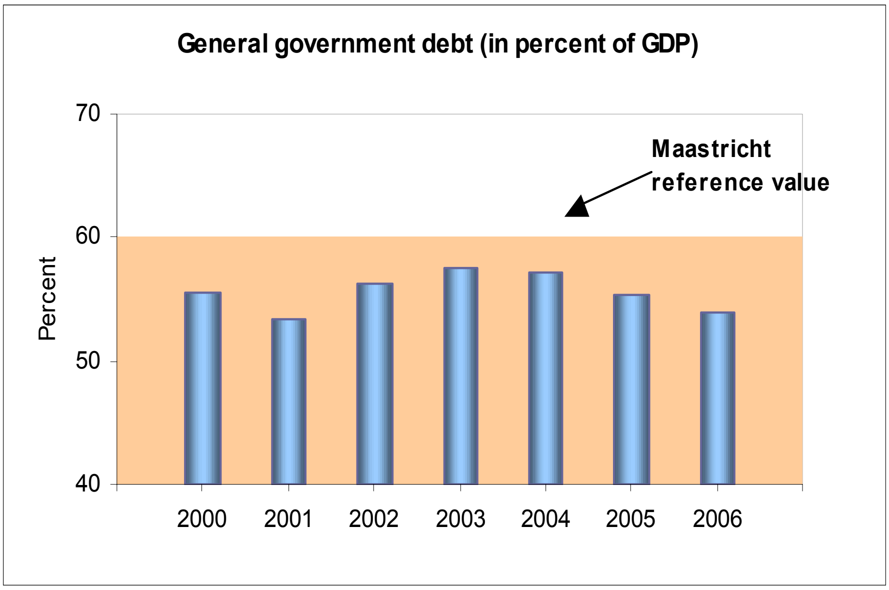
85. In 2003, the deficit is expected to reach 4.8% of GDP. Even though economic growth is slower than previously envisaged, the higher deficit is not attributable primarily to lower revenues. A shortfall amounting to 0.2% of GDP in PIT revenues is to be expected; this may be, however, offset by excess revenues from other sources. Based on the figures of the first seven months of the year, we may reckon with excess revenues of a similar magnitude in the case of VAT as well as corporate and simplified enterprise taxes. Risks arise more on the expenditure side, in particular in case of items where targets are not set in nominal terms but develop according to normative regulation (human normatives, housing subsidies). Outlays that had been impossible to foresee (for instance, the decision of the Supreme Court on the payment of the income supplement for those on maternity leave) also have an effect of increasing expenditures. The risks of the expenditure side are aggravated by the spending of remaining appropriations of budgetary institutions, as well as the increased interest burden due to the central bank interest rate to protect the exchange rate of the Forint. On the whole, risks on the expenditure side may amount up to 0.6-0.8% of GDP, depending on the spending propensity of budgetary institutions.

86. The equilibrium position of local governments is difficult to assess as in previous years it was a tendency for local governments to forecast significant deficits when preparing the budget for appropriations, while by year-end actual figures showed significantly smaller deficits, in some years even a small surplus. Furthermore, in election years the deficit of local governments, just as in the central government budget, tends to increase; this is attributable primarily to heavy investment expenditures. For 2003, the budgeted expenditures of local governments show a deficit of slightly more than 1% of GDP, similarly to previous years, but the actual figures available at this point do not support that proposition. In line with the usual seasonality, the balance of the sub-system showed a surplus in the first quarter. By the end of May, the surplus had declined by approximately HUF 10 billion, but it is still substantial at about three times the amount typical for the first five months in the past two years. The financial management of local governments represents a risk to the general government balance, the magnitude of which is difficult to assess based on the information available at this point. In order to mitigate future risks, the current tasks of the Ministry of Finance include the review, and if necessary re-regulation, of the borrowing limit applicable to local governments.

87. In view of the risks on the expenditure side, the general government deficit is likely to be 4.8% of GDP, and even though it is improbable that each of the risks indicated would materialise, the possibility of exceeding that level by a few tenth of a percentage point cannot be excluded either. The growth of the deficit is slowed by the fact that the Government, in light of the processes in the first months, decided on expenditure cuts amounting to 0.4% of GDP.

88. Should household consumption and wage growth unexpectedly slow down in the second half of the year, risks would also materialise on the revenue side. The Central Bank does not exclude the possibility of the deficit being higher than projected, if the risk of both the lower-than-budgeted tax revenues and the greater-than-budgeted deficit of the local government sub-system come true. The shortfall of tax revenues would be a risk for the next year as well. If revenues develop in line with the NBH projections in 2003, then, due to the lower base, the 2004 balance of the general government might worsen by as much as 0.7% of GDP. However, the Government is committed to achieve the deficit target. If in 2004 a danger of a deficit in excess of the budgeted level was to emerge as indicated by processes during the year, expenditures would be cut to implement the necessary corrections.

89. The gross public debt to GDP ratio fell below 60 % in 2000 already, then in 2001 it went down to 53%. In 2002, the outstandingly high general government deficit caused a temporary increase in the debt ratio. In 2003, the outstanding debt is affected primarily by the level of the deficit and the effects of foreign exchange losses. From 2004 onwards, the rate of the change in debt will be governed by the changes in deficit. Given the reduced deficit, the declining trend of the debt ratio will be resumed and the public debt will decline again to approx. 54% of GDP by 2006.



90. In the medium term the gradual reduction of the redistribution rate continues to be a priority, but in 2004, commitments render it impossible for the growth of expenditures to be below that of GDP. In that year the growth of revenues will be the tool of improving the balance, for which the fundamentals are laid by the proposed changes in the tax regime. In subsequent years, however, the implementation of the priorities of the Government will be greatly assisted by the transfers from the EU budget, and in the environment of the expected higher economic growth, general government expenditures will be reduced as a percentage of GDP. Therefore the balance can be improved while at the same time revenues as a percentage of GDP may decline slightly.

Fiscal development *general government, percent of GDP*

	2002	2003	2004	2005	2006
Receipts*	44,5	cca. 43	cca. 44,5	44-44,5	cca. 43,5
Expenditures*	53,7	cca. 48	cca.48	cca. 47	cca. 46
Deficit	9,2	cca.4,8	cca. 3,8	cca. 2,8	cca. 2,5
*of which: EU transfers	0,2	cca. 0,4	0,5-1	cca. 1	cca. 1

91. In 2004, the Government has the following priorities in the area of expenditures:
- development of the national public road network, in particular the construction of a high speed road network,
- satisfying our obligations arising from EU membership,
- implementation of projects aimed at improving the quality of public services provided by local governments,
- within welfare appropriations, increasing pensions, maintaining the real value of the family allowance, increasing housing subsidies, expanding the free schoolbook and school meal programmes.

92. The legislation adopted at the end of 2002 significantly increased the transparency of general government accounts. The Government intended to eliminate, in the sub-systems of the general government, the intransparent, uncontrollable situation, which is also problematic in terms of the technique of accounting, relating to the development of the high-speed road network and to sureties. Complying with legislative provisions, the Government intends to achieve transparency by assuming debts in order to appropriately present the general government deficit. As part of the Budget Act of 2004, the Government will initiate the adoption of a three-year framework act by Parliament. To enhance stability and predictability, the framework act will set out for 2005 and 2006 the long term determining factors, commitments as well as the general government deficit as a percentage of GDP. Target figures will be specified for the revenues and expenditures of general government as a percentage of GDP, the changes in the ratios of expenditures by functional and economic classification, and public debt.

3.2 Budgetary aspects of EU accession

93. After accession, Hungary will be eligible for grants from the EU budget, and as a Member State, it will have to contribute to the Community budget. In 2004, the balance of the Community financial relations is expected to improve in the current account of the balance of payments, while transfers between the Community and Hungary do not directly improve the general government balance. Our calculations are based on the Accession Treaty, the grant disbursement schedule assumed during the accession negotiations and (in respect of the Structural Funds) on the National Development Plan. We expect the disbursement of pre-accession instruments (PHARE, ISPA, SAPARD) undisbursed by the end of 2003 to happen in 2004 and thereafter, and the utilisation of the entire amount of grants available (commitment appropriations). On the whole, the amount of funds from the EU budget used (including the budgetary compensation) will be somewhat in excess of 1% of Hungarian GDP in 2004, and they will approximate 2% of GDP in 2005 and 2006.

94. After accession, 75% of customs revenues will be paid into the Community budget, therefore we must expect revenues to decline in this area. Furthermore, new expenditure items will appear in the form of the so-called VAT-based and GNI-based contributions, as well as the contributions due to the UK rebate, to be paid into the Community budget. These new expenditures are expected to be around HUF 120 billion in 2004, and HUF 200 billion in 2005 and 2006. The other items payable outside the Community budget (e.g. the capital contribution to be paid to the European Investment Bank) will also be paid from the central budget.

95. Some of the EU transfers will appear both on the revenue and expenditure side of the Hungarian budget, that is, they have no direct effect on the balance. The direct agricultural payments and agricultural market subsidies, and other payments under the title of internal policy, however, will not be part of the national budget. However, the agricultural subsidies of the EU will replace some of the present agricultural subsidies, thereby somewhat reducing the burden on the budget. The lump-sum cash flow budgetary compensation will also improve the budget balance.

96. The sum total of funds available from the EU and included in the national budget (together with the budgetary compensation) is expected at around HUF 200 billion in 2004, HUF 245 billion in 2005 and HUF 270 billion in 2006 (approx. 1% of GDP). Because of the principle of additionality, the items previously spent from domestic sources on the objectives supported by the Structural Funds are still pre-requisites for the eligibility for transfers from the Funds. Therefore in this area no savings should be expected in the budget. Provision for the co-financing element for the grants from the Structural Funds, the Cohesion Fund and the regional development grants from the Guarantee Section of the EAGGF is a determinant and a priority in the expenditures of general government.

97. On the whole, as the direct financial result of accession, the balance of the central government budget is expected to deteriorate in 2004, while some of the indirect additional revenues arising from the various multiplicator effects will offset the negative impact in later years.

3.3 Sensitivity analyses, cyclical trends

98. According to the sensitivity analyses, a 1% change in GDP has the effect of changing by 0.289 percentage points in aggregate the general government balance to GDP ratio in the year concerned. In the course of the calculations, we took into account the main tax and contribution revenues, representing some four-fifths of the revenue side, as well as the expenditure items relating to changes in wages, salaries and unemployment. However, the sensitivity coefficient indicates the impact of changes in GDP on the balance assuming an unchanged internal composition of GDP. If the composition of GDP changes, the sensitivity indicator must follow suit. For instance, under the alternative scenario called 'slower economic recovery', the cca. 0.5 percentage point lower growth in 2003 already would, using a 0.289 sensitivity coefficient, increase the deficit by approximately 0.2 percentage points in 2004, while at the end of the period the cumulative effect of the difference could be as high as 0.4 percentage points. However, under this, the lower growth would be achieved in a structure different from that assumed in the most likely baseline scenario, thus the impact calculated based on the sensitivity indicator would not emerge. The difference is attributable primarily to the lower level of investment and exports, which has barely any impact on general government revenues, and deficit would not rise despite the lower growth rate.

99. This was the first time that we prepared experimental calculations for the development of the cyclically adjusted (structural) general government balance. The absence, or brevity, of the available time series rendered it impossible to estimate the growth potential of the economy using a production function; instead, we used a simpler method, a so-called HP-filter. Taking into consideration the uncertainties inherent in the method, the results suggest that the Hungarian economy performs below its potentials at present, and the potential growth rate is around 4 percent. The cyclically adjusted balance is better than the actual figures; early in the period, the difference is close to 0.5 percentage points.

Estimation of the structural deficit

Calculation of the output gap

The cyclically adjusted balance (CAB) can be derived from the actual budget balance (BB) with the following adjustment:

$$\mathbf{CAB = BB - A*OG,}$$

where OG is the output gap, while A is the so-called general government sensitivity coefficient.

The output gap is the difference of the actual and potential output (GDP). For estimating potential output using a production function, as recommended by the European Commission, we would need the time series of the stock of fixed assets. In the absence of this, we have resorted to the formerly accepted procedure, that is, we estimated potential output using a Hodrick-Prescott filter over quarterly GDP figures.

Output gap

	2000	2001	2002	2003	2004	2005	2006
GDP at 2000 market prices, annual percentage change	5.3	3.8	3.3	3.5	3.5	4.2	4.7
Potential GDP at 2000 market prices, annual percentage change	4.3	4.2	4.0	4.0	4.0	4.0	4.0
Output gap, as % of potential GDP	0.7	0.4	-0.4	-0.8	-1.2	-1.1	-0.4

Calculation of the sensitivity indicator

On the *revenue* side, beside personal income tax, corporate income tax, contributions and consumption related taxes, other taxes on products and services were also taken into consideration because they represent a relatively large proportion within other tax revenues and are highly dependent on income developments. The business tax imposed by local governments constitutes the decisive part of this item.

Among *expenditures*, we examined three items: pension expenditures, the budgetary deficit funding payable from the budget to the pension fund due to transfers into the private pension system, and outlays relating to unemployment. In Hungary wage increases have a significant effect on pensions, and thus on pension expenditures, in accordance with the Swiss indexation, therefore it is appropriate to take this effect into consideration. The compensation for transfers into the private pension system depends on the rate of wage increases. Though unemployment-related expenditures are below the OECD average, they are included in our calculation.

The calculation methodology is totally analogous for revenue and expenditure items. Elasticities were determined in three steps (see Table).

Columns 1 and 2 contain estimates for the elasticity of tax and contribution revenues and expenditure items according to their respective bases.

In the case of VAT, elasticity can be estimated both directly through GDP and indirectly through household consumption expenditures. Therefore the elasticity figures in the Table take into consideration both of them.

Columns 3 and 4 show the GDP elasticity of the bases as short-term coefficients of econometric equations. (The bases in Columns 1 and 3 are not entirely identical, though the difference is negligible.)

According to our calculations, the income elasticity of the purchased consumption of households is 1, therefore the GDP elasticity of the purchased consumption of households can be substituted with the GDP elasticity of wages and incomes. The tax basis for other products and services is deemed to be wages and salaries and operating profits, in accordance with the calculation of the business tax, the key element in the category. (From among wages, operating profits and GDP, we found GDP to be the most reliable basis in statistical terms as well.) In the case of pension outlays and the deficit funding payable to the pension fund due to transfers into the private pension system, the GDP elasticity of the base is identical with the GDP elasticity of wages and salaries. The elasticity of unemployment benefits to the number of unemployed is 1. Based on a VAR calculation, the GDP elasticity of the number of unemployed is -0.55.

Column 5 shows the size of the considered general government items in relation to GDP, taking the budgetary appropriations and GDP for 2003.

The items taken into consideration represent almost 35% of GDP and approximately 80% of the consolidated gross revenues budgeted for 2003.

Column 6 contains the sensitivity indicator multiplying the elasticity indicators for the various budget items (2) (4) by their weights (5) The elasticity coefficient for the general government balance is **0.289**, that is, a 1 percentage point increase in the output gap improves the cyclically adjusted balance of the government sector by 0.289 percentage points.

Calculation of the sensitivity indicator of the general government

	sensitivity of budgetary item to the respective base		*sensitivity of the respective base to GDP*			
Revenues	*base*	*sensitivity*	*base*	*sensitivity*	*the share of budgetary item in GDP*	*sensitivity*
	(1)	(2)	(3)	(4)	(5)	(6) = (2)*(4)*(5)
Personal income tax	taxable income	1,09	wages and salaries	0,798	7,3%	0,064
Social contributions	wages and salaries	0,93	wages and salaries	0,798	11,5%	0,085
Corporate tax	profit before taxation	0,91	Operating surplus	2,44	2,2%	0,050
VAT	purchased consumption, GDP	1,17	purchased consumption, GDP	0,798	8,5%	0,079
Excises	purchased consumption	1,00	purchased consumption	0,798	3,5%	0,028
Other taxes of goods and services	GDP	1,20	GDP	1,00	1,9%	0,022
Total					**34,9%**	**0,328**
Expenditures						
Pensions	wages and salaries	0,57	wages and salaries	0,798	7,9%	0,036
Allowance for loss of the state pension fund because of the private pension fund system	wages and salaries	1	wages and salaries	0,798	0,6%	0,005
Unemployment benefit	number of registered unemployed	1	number of registered unemployed	-0,55	0,4%	- 0,002
Total					**8,8%**	**0,039**
Balance					***26,1%***	***0,289***

The effects of the economic cycle on the balance of the government sector until 2006 are shown in the following table.

Cyclical adjustments of general government balance

	GDP growth (%)	Potential GDP growth (%)	Output gap (OG)	Sensitivity of general government balance (A)	Cyclical budgetary component (A*OG)	General government deficit (% of GDP)	Cyclically-adjusted deficit (% of GDP)
2003	3.5	4.0	-0.8	0.289	-0.222	4.8	4.6
2004	3.5	4.0	-1.2	0.289	-0.356	3.8	3.4
2005	4.2	4.0	-1.1	0.289	-0.307	2.8	2.5
2006	4.7	4.0	-0.4	0.289	-0.112	2.5	2.4

3.4 Structure of revenues and expenditures

3.4.1 Tax and contribution policy

100. The majority of changes envisaged in **tax policy** for the 2004-2005 period can be directly derived from the economic policy priorities or from the requirements of EU accession. One of the priorities for the forthcoming years is the reduction of the general government deficit, but this must be implemented in such a manner as to also improve the economic environment for enterprises and provide for considerations of social solidarity. To this end, the implementation of taxation measures aimed to improve competitiveness, the maintenance of the tax exempt status of employees earning minimum wage and the simplification of administration for taxpayers continue to be requirements during the reform of tax policy.

101. In 2004, the ratios within the tax and contribution system will be altered; the direction of change is shown in the following table:

Main components of revenues *percent of GDP*

	2002	2003	2004	2005	2006
Corporate income tax	2.3	2.4	2.4	cca. 2.5	cca. 2.5
Import duties	0.8	0.7	0.2	cca. 0.1	cca. 0.1
VAT	8.1	8.7	9.3	cca. 9.5	cca. 9.5
Excises	3.5	3.5	3.5	cca. 3.5	3-3.5
PIT	7.5	7.2	8.2	cca. 8	cca. 8
Social contributions	12.9	12.7	12.9	cca. 12.5	cca. 12

102. In the **social security** contribution system, the reduction of burdens on employers continues to be an objective, but, due to the determining factors in budgetary expenditures, the implementation of this will be slower than originally envisaged. Therefore the further reduction of the lump-sum health contribution is scheduled for 2005. However, from 2004 onwards a special subsidy arrangement will promote the hiring of long-term unemployed above the age of 50, and part time employment related to the childcare allowance and benefit. The simplification of administration relating to contribution payment and the propagation of the electronic filing of returns remain priorities. Compensation, and the gradual provision of financing, for the future burdens on the social security and social benefit systems resulting from the change in the age composition of the population is another key objective of contribution policy. This can be achieved through the introduction of a nursing insurance system in compliance with the European standards of nursing the elderly as well as by the gradual incorporation of agricultural small producers into the mandatory insurance system.

103. The overhaul of certain tax concessions will result in a simpler, more transparent **personal income tax** system. To assure uniform taxation of income from different sources, the tax rate applicable to separately taxed income elements should be approximated to that of income subject to consolidated taxation.

104. As regards the **corporate income tax and dividend tax**, the fundamental objective is to enhance competitiveness and to fulfil the law approximation obligations. To this end, the proposed measures include the relaxation of the conditions of development tax concessions aimed at encouraging investments and of the rules of the accrual of losses, in line with the practices of several Member States of the European Union.

105. The terms of the so-called **simplified enterprise tax**, which was introduced in 2003 to offer a simplified tax regime to small enterprises, will be clarified and simplified based on the experiences gained.

106. In the field of the **value added tax**, the EU approximation requirements will be fulfilled, and the VAT rates will be modified to improve competitiveness. Pursuant to the Community tax regime, the zero percent rate cannot be retained, therefore the products currently falling into this bracket will have to be reclassified into the minimum VAT rate as defined by the EU. Simultaneously with the raising of the reduced rate, the present standard rate will be lowered while some items will be reclassified from the reduced to the standard rate. Pursuant to the EU directive, the strict rules prohibiting tax reimbursement will be relaxed, the rules governing the deduction of VAT corresponding to subsidies in the case of new investment projects will be modified, and the present zero percent rate for acquisitions financed from pre-accession funds will be abolished. The addition of new products to those eligible for the reduced rate is under consideration; examples include products and services certified as environment friendly, organic foods and their raw materials, printed and electronic media products explaining and propagating sustainable development and environment protection, and, pursuant to the provisions of separate legislation, energy derived from renewable sources in an environment friendly manner.

107. The consumption tax on motor vehicles will be converted into a **registration tax**. In the **excise** system, the fulfilment of law approximation obligations will continue, and tax rates will be modified taking into account considerations of competitiveness. The possibility of increasing the excise tax concessions for liquid gas fuels is being examined, while, pursuant to other legislation, the exemption of bio-diesel fuels from the excise tax will be registered.

108. In the field of **customs**, customs regulations to remain in national competence, effective from the time of accession, will be introduced. While national interest can be enforced, the possibility to autonomously shape the customs regime will cease to exist upon accession. After accession, Hungary, which will become a full member of the single customs area of the EU, will directly apply the customs law and customs procedures of the Community as well as the system of tariffs and tariff allowances underlying the trade policy of the Community.

109. Parallel with the modernisation of the financing system of local governments, the modernisation of the **local taxation** system will also continue. In order to improve the competitiveness of enterprises, the base of the local business tax will be slightly modified. As one of the instruments to achieve taxation proportion to wealth, plans include offering the possibility to apply a novel taxation regime for building and land taxation, based on assessed value.

110. To prevent increased environmental pollution, from 2004 a new type of tax, the **ecological tax** will be introduced, with the **energy tax** on the energy sector, satisfying

the minimum requirements of the EU, as one of its elements. The importance of this type of tax will gradually increase in the coming years.

3.4.2 Changes in the composition of expenditures

111. Due to previous commitments, the expenditures of general government would increase considerably. However, the reduction of the deficit demands the deceleration of the rate of growth of expenditures, which in turn necessitates changes in the composition of expenditures. To assure financing for the key objectives, laid down in the government programme, the reclassification of tasks is called for on the expenditure side. In all areas, it has to be carefully reviewed which tasks should and could receive budgetary support and to which extent. Thus in the future the deceleration of the growth rate of expenditures will not result from general, across-the-board changes. In certain priority areas, decisions have already been taken on measures, amounting to reforms, which will bring about the reduction of the hitherto rising costs. In health care the introduction of more modern forms of care and the appearance of entrepreneurial capital (hospital privatisation), in public administration the implementation of regionalisation and the review of the financing, tasks and competences of local governments, while in defence, the creation of a small but more efficient army will result in a more reasonable level of expenditures.

112. In the 2004-2006 period, capital formation expenditures represent a significant ratio within public expenditures. In addition to domestic sources, funds from the European Union will play a role in their financing. With the help of EU support, concentrated investments will be implemented in transportation (expansion of the national public road network, reform of railway transport), and in environment protection (nature protection, water management related investments, II. National Nature Protection Basic Plan, Vásárhelyi Plan).

113. The government considers it a high priority to maintain the value of pensions, social benefits and wages. To this end, in addition to increasing welfare expenditures, the 13th month pension will be gradually introduced.

114. The Government strives for a smaller but more efficient public administration. In order to improve effectiveness, both the tasks and the staffing levels will be reviewed in the institutional sector.

3.4.3 Investment objectives of the public sector

115. In 2003, the general government will devote close to 6% of GDP to capital type expenditures and subsidies. This ratio, taking into consideration the growth in EU funds, may increase slightly between 2004 and 2006. This will facilitate the commencement and financing of new investment projects defined as priorities, such as the ones related to the expansion of the high-speed road network and to institutional development, and the implementation of ongoing public investments encompassing every important sector of the economy.

116. Within the capital expenditures of the public sector, the investments to be implemented or supported by government agencies represent approximately 70%. These mostly consist in infrastructure and economic development projects, regional and rural development investments, innovation promotion as well as environmental and institution development projects. The investments of local governments (mostly communal infrastructure, environmental and economic development projects) represent some 28% of the capital expenditure and support provided by the public sector. The remaining 2% comes from investment and capital transfers by the extra-budgetary funds and the social security funds

117. The investments implemented in 2004-2006 will mitigate regional differences, improve the competitiveness of economic participants and, while improving environmental conditions and preserving nature, contribute to the development of infrastructure. The investment projects relying on the efficient use of domestic and EU funds (e.g. in the field of infrastructure or environment and nature protection) will be implemented in line with the investment objectives specified in the National Development Plan, as part of those objectives.

118. The reallocation and expansion of domestic funds, and through that, the creation of conditions for additionality, will result in the ability to obtain EU funds of HUF 116 billion (EUR 0.5 billion) in 2004, HUF 175 billion (EUR 0.7 billion) in 2005, and HUF 191 billion (EUR 0.75 billion) in 2006 to support public or private investments. The related domestic co-financing, consisting of part of the capital expenditures of the public sector and the expenditures of the private sector, will amount to HUF 47.4 billion (EUR 0.2 billion) in 2004, HUF 68 billion (EUR 0.27 billion) in 2005 and HUF 74.3 billion (EUR 0.3 billion) in 2006.

3.5 Measures to improve control over expenditures and the efficiency of tax collection

119. In respect of the internal financial control of the general government, the central harmonisation and co-ordination function of the Ministry of Finance must be reinforced in the field of the in-process, ex ante and ex post management control and internal audit.

120. In the internal financial control system of the Hungarian general government, the introduction of internationally accepted internal control standards, the increase of the number of experts participating in internal control and the reinforcement of the functional independence of internal auditors are still important objectives.

121. The amendment of the control chapter of the Act on the Tax Procedure, effective since 1 January 2003, specifies the types of audits that the tax authority may conduct to attain its control objectives. As a novel feature, the act now expressly defines the type of audit resulting in a period closed with audit (audit aimed at the ex post examination of returns). The Act also specifies time limits for the various types of audit. As a result, the tax authority conducts audits based on a realistic audit plan and it becomes clear for taxpayers which tax obligation and within what time limits is examined through the various types of audits. The amendment aimed to improve the efficiency of auditing provides for the extension of time limits applicable to audits in justified instances. In most cases such extension requires the intervention of the superior body, therefore it broadens the scope of application of the supervision of legality.

122. As a modification of audit rules, the Act sets forth the criteria based on which the tax authority must formulate its audit plan. The act obliges the President of the national tax authority to publish an audit directive every year, also specifying the mandatory content elements of such directive. The intention of the legislators is to improve the effectiveness of tax audits in future through those measures.

123. The rules governing tax enforcement action were modified as of 1 January 2003 with an eye to their modernisation and enhanced efficiency. The most important changes include the expansion of the scope of documents to serve as the basis for enforcement actions in that, beyond the decision of the tax authority, any decision of an authority imposing a payment obligation may be considered for this purpose. Thus the tax authority has been relieved from the obligation to issue additional decisions. If the competence of the tax administration body implementing the enforcement action is terminated, the procedure does not become void under the amendment, that is, the previously completed procedural acts need not be repeated.

124. As one of the most significant changes in the enforcement rules, the principle of gradualism will no longer be applied. As of 1 January 2003, the tax authority has the discretionary power to decide which enforcement action to take first, and it may even provide for several actions to be taken simultaneously. There are two fundamental constraints, however. Attached real property can be sold only if the tax arrears cannot be covered from other assets or cash receivables, while housing property can be sold only as the last resort.

125. As regards the directions of development of auditing by the tax administration, audits aimed at the collection of data, assessment and enrichment audits are priorities as tools of discovering real tax bases, with special emphasis on taxpayers using itemised cost accounting. In the context of EU accession, taxpayers switching from assessment by the tax authority to self-assessment must be subjected to more intensive control in respect of import VAT, which means, as the general rule, taxpayers participating in Community trade. The adequate establishment and operation of more intensive fiscal co-operation with Member States and the processing of information thus acquired represent additional tasks.

126. Increasing the number of auditors is one of the elements of enhancing audit efficiency; one of the sources for the additional staff may be the personnel becoming redundant at the customs authority upon the termination of border control. This personnel can be used primarily for operative audits aimed at data collection and, in some part, for import VAT audits.

127. A more long term objective is to communicate the reasons for taxation to taxpayers, to make taxation more popular, to raise tax awareness, that is, to disseminate in a wide circle the notion that taxation is an obligation of every citizen, while tax evasion defrauds not only the state but also other taxpayers. This objective can be achieved through appropriate publications and forums.

3.6 Public debt management

128. The task of the Government Debt Management Agency (ÁKK) is to provide for the financing requirement of the budget at minimum cost in the long term and at acceptable risk levels. The goal of the simultaneous optimisation of costs and risks is to achieve a debt structure with the best cost/risk ratio in the long term. In order to achieve those objectives, ÁKK determines the foreign currency/Forint composition of the debt portfolio and, in the case of the Forint debt, the average maturity.

129. In the case of the foreign currency/Forint ratio, it is a fundamental consideration that the debt and interest rate fluctuations arising from changes in the exchange rate are detrimental to the predictability of debt management, therefore the objective is to gradually reduce the share of debt denominated in foreign currency. ÁKK refinances maturing foreign currency debt in foreign currency, while financing the interest on foreign currency debt by issuing Forint debt. This means that, as a rule, net foreign currency issuing does not happen. In the course of managing the foreign currency debt, other macro-economic considerations must also be taken into account, in which case the aforementioned rule may be broken.

130. In case of the Forint debt, the goal is to smooth the maturity structure of the debt. An even maturity structure helps minimise the refinancing risk in case of any market disruptions. The preference of longer maturities is another key consideration, which serves to reduce the annual renewal requirement and also to limit the interest rate risk.

131. ÁKK considers direct sales of government securities to households as a priority. Household savings represent a stable and low-cost alternative financing for the purposes of debt management.

3.7 Budgetary risk analysis

132. The debt portfolio secured by a Government guarantee or surety decreased from HUF 997 billion in 2001 to HUF 922 billion at the end of 2002 – corresponding to a decrease from 6.7 % to 5.4% of GDP. The ratio of cashed sureties to the total portfolio fell from 1.00 % in 2001 to 0.44% in 2002. The appropriations in the central government budget to cover the cashing of guarantees have always proved sufficient; furthermore, the recoveries of previously cashed guarantees have largely compensated for the necessary payments. This was also promoted by the fact that the budget frequently assumed credits backed by government guarantees, therefore no payment had to be made in respect of those items under the heading of the cashing of guarantees. In 2002, the budget assumed government guaranteed credit corresponding to 2.2% of GDP.

133. In order to reduce the risk of the cashing of guarantees or the assumption of debt and to increase transparency, since 1 January 2003, the amendment of the Act on Public Finances, the Government has not been allowed to provide a guarantee in cases where the obligee is unlikely to meet its payment obligations without cashing the guarantee or resorting to other budgetary funds. In other respects, there have been no changes in the provisions of the Act on Public Finances applicable to the general reserves, the acts governing government guarantees and counter-guarantees, or the management of risks arising from privatisation agreements by the ÁPV Rt.

134. The removal of the quasi-fiscal functions of the Hungarian Development Bank Rt. at the end of 2002 significantly improved transparency in respect of budgetary risks.

4. STRUCTURAL REFORMS

135. The key objectives of the government programme as regards structural reforms were presented in the PEP 2002. Therefore in this chapter we will focus only on those areas where changes have occurred or new issues have been raised. Where work is ongoing according to the original timetables, we will only refer to the issues concerned.

4.1. Enterprise sector

4.1.1 Small and medium-sized enterprises

136. Accession to the European Union will present a significantly greater challenge to small and medium-sized enterprise (SMEs) than to large undertakings. Having realised this, the Hungarian Government elaborated and adopted the Széchenyi Enterprise Development Programme at the end of 2002. The Programme is a medium term SME-development concept complying with European Union requirements (covering the period of 2003-2006), integrating the enterprise development programmes and support instruments (applications, financial arrangements, information provision) into the framework of a single programme.

Applications

137. In the call for applications under the Széchenyi Enterprise Development Programme, three main objectives are enforced: normativity, transparency and EU-compatibility. In 2003, HUF 8.1 billion is available for providing support to applicants. In addition, the funds in the appropriation to promote investments by small and medium-sized enterprises within direct regional development grants are also available.

138. Through the applications, non-repayable grants are available for investment projects for the modernisation and technological improvement of micro- and small

enterprises in the processing industry; the introduction of state-of-the-art corporate governance systems; the use of business consultancy services to improve competitiveness; trade-specific training for compliance with EU requirements; improvement of supplier operations; networking of enterprises; introduction and certification of quality management systems; presence on the Internet; interest subsidies for the repayment of investment loans.

139. In addition to the Széchenyi Enterprise Development Programme, other application schemes managed by the Ministry of Economy and Transportation are also available to SMEs (Energy, SMART), but experiences indicate that these are appropriate primarily for larger undertakings. SMEs are also covered by certain preferences of the Operational Programme for Economic Competitiveness.

Financing

140. In the course of modernising the special facilities to help micro-, small and medium sized enterprises to obtain credit, we intend to create a transparent credit programme relying on our past achievements. The Ministry of Economy and Transportation, in designing the various facilities, strives to make them as self-sustaining as possible and to make them rely more on money market than on budgetary funding sources than it used to be customary. The acquisition of financing will be assisted by a multi-stage system:

- Within the Micro-credit Programme, micro-enterprises that are not yet eligible for bank financing due to their history or the size of the project concerned will be eligible for a maximum of HUF 3 million funding.
- The ceiling of the working capital loan available through the Széchenyi Card will be raised from HUF 1 million to HUF 5 million.
- The "*Midi-credit*" facility will provide HUF 3-10 million of investment credit, partially usable for working capital financing as well, to micro- and small enterprises.
- Under the Európa Credit facility modernisation projects of HUF 10-500 million, which add value and increase the level of processing of products, may be supported. For the financing of the facility, the Hungarian Development Bank Rt. provided a credit facility of HUF 80 billion to the SME sector, which is backed by a government exchange rate guarantee.
- The Ministry of Economy and Transportation provides a 50% subsidy to the guarantee fees payable for joint and several sureties required for loans taken out by SMEs not exceeding HUF 40 million.
- In line with the EU practice, the MFB Rt. has launched a Development Equity Investment Programme with a HUF 40 billion facility. In the course of the investments, the equity stake of the bank may not exceed 49%, and the stake must be sold within five years.
- The MFB Rt. has also increased the equity of Corvinus International Investment Rt. by HUF 7.5 billion, thereby promoting the expansion of investments of Hungarian SMEs in countries outside the European Union.
- The Regional Development Holding (RFH) assists developments and projects implemented by undercapitalised undertakings by investing venture capital and thus becoming a co-owner.

Other instruments supporting the SME sector

141. The "EU comes to your doorstep" programme was launched in 2003; under this programme, technical presentations will be delivered in every micro-region of Hungary on general issues as well as issues of particular relevance for the micro-region concerned, thereby assisting the preparation of local undertakings.

142. The Government provides a predictable, stable environment in the long term for enterprises by gradually diminishing the tax and administration burdens. The introduction of the Simplified Enterprise Tax has significantly reduced administrative and tax burdens

on micro- and small enterprises with turnovers below HUF 15 million that have been operating for at least 2 years. In addition to the capital investment tax base allowance, which was introduced in 2001 for micro- and small enterprises and which proved to be highly successful, the so-called development reserve was introduced in 2003. This allows for the use of profits generated in the previous year for investment purposes free of taxation.

143. From 15 October 2002, the Multi-annual Programme for Enterprise and Entrepreneurship of the Commission became available for Hungary as well. Nine of the expert working groups set up to implement the projects under the programme have members delegated by Hungary already. Hungary received support through applications for the implementation of two new Euro Info Centres in 2003.

144. A survey of small and medium-sized enterprises revealed that the regulatory environment of this sector complies with EU requirements, but the definitions of micro-small and medium-sized enterprises, as applied in Act of 1999, set lower turnover and total asset criteria than those contained in the most recent recommendation of the Commission issued on 6 May 2003. In view of this, the SME Act needs to be amended; the effective date of the amendment is expected to be 1 January 2005.

4.1.2 Transport

Road network

145. Pursuant to the government resolution adopted in spring 2003 on the long- and medium-term tasks and financing of the development, maintenance and operation of the national public road network, priority will be given until 2006 to the expansion of the high speed road network forming part of the pan-European network stretching from border to border and spanning the country in the north-south and east-west directions, also alleviating the capital-focused character of the network, with such density as to assure good access to each region from other regions with ties to it. According to that programme, 420 kilometres of new high-speed roads will be built and the construction of 425 kilometres of high-speed roads and preparations for the construction of another 803 kilometres of such roads will be commenced between 2003-2006. The construction of the motorway ring around the capital will be continued. Two new bridges will be established across the Danube: one north of the capital, the other at Dunaújváros. In line with the National Regional Development Plan, bridges facilitating the crossing of the Tisza River will also be constructed.

146. In line with European Union requirements, the length of roads capable of bearing 115 kN axle load will increase, in addition to the high speed roads, to 7000 kilometres by 2008 as a result of the reinforcement of trunk roads and regional roads. In respect of municipal public roads, two thirds of which are now paved, 100 percent will be covered with pavement in Budapest and large cities in the medium term, and in all the other settlements by 2015.

147. In order to assure uniform standards of service and maintenance technology, the management of public roads will be gradually separated from the ownership and supervision of roads, in line with the practice in EU Member States.

Railway transportation

148. Discussions between the Government and representatives of the railway sector on the establishment of an EU-compatible system of Hungarian railway transportation and the reform of the financial management of the Hungarian Railways (MÁV Rt.) will be held in the second half of 2003. The reform will be based partly on developments already implemented, while in another part state assistance will be requested for compliance with

European Union requirements and the more efficient provision of higher quality services. In the reform programme, a new system of government assistance to the railway sector will be elaborated, allowing for the separate subsidisation of public services (passenger transport, track management) only.

149. The decree on the accounting separation of railway functions within the railway company assures the separation, within the railway companies, of passenger transport, freight transport, track maintenance, traction and rolling stock maintenance business lines; furthermore, a central management and supporting service organisation has been established within the railway company. As a result of the accounting separation, the profitability of each function can be measured and the legality of the use of government subsidies can be controlled.

150. The decrees of the Ministry of Economy and Transportation on track use tariffs and on the distribution of track capacities of the national public railway track system are about to be approved. In 2004, the Minister of Economy and Transportation will set up a new budgetary organisation responsible for the non-discriminatory distribution of track capacities and setting the track use tariffs (Railway Track Capacity Distribution Agency).

151. The draft of the new Railway Act will be completed by the end of 2003, which will endeavour, i.a., to place the public service agreement between the Government and MÁV Rt. on a market basis. In the course of the drafting of the act, the possibility of terminating the exclusive state ownership of railway sidelines will be considered.

4.1.3 Housing programme

152. Following on the priorities of the housing policy of recent years, more effective government support of the housing conditions of families with children has been given more emphasis. Last year the Government increased the amount of the housing construction allowance, and its further increase is proposed in several stages simultaneously with expanding the scope of eligibility.

153. The legislative amendment of June 2003 made the system of housing subsidies more efficient and more equitable. The ceiling for mortgage bond backed loans was lowered from HUF 30 million to HUF 15 million so that taxpayers' money is used towards supporting legitimate housing needs rather than the purchasing of luxury homes. After the changes, any one person may have only one subsidised borrowing at any time. The legislative changes did not result in higher interest rates on subsidised loans or increased burdens on borrowers.

154. In the future the Government intends to accelerate the rental dwelling construction programme, where a significant role is proposed for private business capital. In this context, the introduction of a rent subsidy system, on a means tested basis, is proposed already from 2004.

155. The clarification and reinforcement of the role of housing and construction policy within the Government is underway. The Government will set up a new, independent public administration body with national competence within the Ministry of Interior to regulate and supervise that area.

4.1.4 Development plans of the Government

156. The **National Development Plan** (NDP) has been completed based on the Regulation on the general rules governing the Structural Funds, setting out for the period of 2004-2006 the operational programmes implementing development objectives jointly funded with the European Union. The long-term objectives of the NDP strategy include the improvement of the quality of life and the narrowing of the lag behind the EU

average in terms of per capita income. The NDP, in order to better exploit human and environmental resources and to promote competitiveness and more balanced regional development, has defined 5 operational programmes:

- the Human Resource Development Operational Programme (HRDOP) sets out to increase employment and to improve the competitiveness of labour (active labour market programmes, qualifications appropriate for labour market demand, improving the health of the labour force) and the promotion of social integration.
- the Economic Competitiveness Operational Programme (ECOP) intends to improve the general competitiveness of the economy by supporting modernisation projects in the productive sector. Social cohesion and expanded employment is promoted by the technical modernisation of small and medium-sized enterprises and assisting innovation, research and development, network building as well as the establishment of the e-economy.
- One objective of the Agricultural and Rural Development Operational Programme (ARDOP) is to modernise and increase the efficiency of agriculture by improving production technologies on the one part and product processing on the other part. Other objectives include the development of rural areas, the provision of sources of income for rural population, improvement of rural infrastructure and services, protection of the cultural heritage of rural areas and implementation of the National Agri-environmental Programme.
- The Regional Operational Programme (ROP) comprises regional and urban development projects to be implemented within regions. The measures of the programme improve the economic environment by supporting tourism, implementing certain infrastructure development projects, assuring integrated spatial and urban development and developing the human resources and knowledge base of the regions.
- The Environment and Infrastructure Operational Programme (EIOP) sets the objectives of implementing environmentally friendly investments, in concert with developments financed from the Cohesion Fund. The environment and nature protection and transport infrastructure development measures proposed in the EIOP will implement the objectives of the Programme by enhancing environmental safety, strengthening nature protection, the environment friendly transformation of energy management, the development of environment friendly transport infrastructure and improvement of the accessibility of transport infrastructure.
- Furthermore, the National Rural Development Plan (NRDP) and the National Agri-environmental Programme also play an important part in the implementation of the NDP and the regional programmes.

157. The strategy of the Cohesion Fund is organically linked to the National Development Plan, having been prepared simultaneously and in co-ordination with the latter. The criteria of the segregation of the Structural Funds and the Cohesion Fund – project objectives, project size, project selection criteria – are set forth in the sectoral strategies and the strategies of the operational programmes of the National Development Plan.

158. Tasks for 2003 include the discussion of the NDP with the European Union to elaborate the Community Support Framework; accordingly, the organisational and regulatory framework of the planning, utilisation, control and monitoring activities of objectives to be implemented in co-finance with the EU funds must be devised.

159. In the course of preparing the central application programme for supporting job creation investments in 2003, the Labour Ministry placed special emphasis on providing additional support possibilities to enterprises operating in socially or economically disadvantaged regions, and on giving preference to projects linked to local economic development programmes.

160. Those projects are eligible for non-repayable subsidies which are implemented in socially, economically and infrastructurally underdeveloped regions, or regions with

unemployment significantly above the national average, as well as in micro-regions affected by the closure of coal mines decided by the Ministry of Employment and Labour Policy, and the applicant undertakes to employ, after the completion of the project, unemployed registered by the labour offices. The HUF 5 billion government assistance available in aggregate is expected to help in establishing some 5000 new jobs.

161. In 2002, job creation was assisted by a system of subsidies to promote entrepreneurship and to supplement tourism development programmes under the Széchenyi Plan. With the help of the grants awarded, the beneficiary enterprises/sole proprietors will create some 3000 new jobs through the implementation of their projects.

162. In 2002, the regional development councils of the five least developed counties in social and economic terms as defined in the Budget Act (Borsod, Szabolcs, Nógrád, Somogy and Békés counties) awarded grants to 70 enterprises. Using those grants, the enterprises established over 1000 new jobs. The grants not only promote the creation of new jobs but also contribute to maintaining the existing jobs at the sites affected by the investments. In 2003, pursuant to the agreement between the Ministry and the regional development councils, the councils of the seven least developed counties in social and economic terms as defined in the Budget Act (Borsod, Szabolcs, Nógrád, Somogy, Békés, Bács-Kiskun and Szolnok counties) will receive a total of HUF 710 million of decentralised funding for the purpose of job creation.

163. At the end of 2002 a separate call for applications was issued for assistance to job creation projects in settlements located in regions with the worst employment situation; in the framework of this, 62 enterprises/sole proprietors were awarded non-repayable grants. The projects create 352 new jobs. 80% of those hired for these positions had been unemployed. From 2003 onwards, the catching-up of the least developed regions of the country and the intensification of the development of enterprise zones will be assisted by increased amounts of appropriations.

164. At the beginning of 2003, the National Development Bank Rt., primarily with the involvement of the commercial banking system, launched the Európa Technological Development Investment Credit programme with a HUF 150 billion credit facility. The main objective of the credit programme is to promote investments aiming at the alignment of Hungarian enterprises to the market conditions of the European Union as soon as possible, the enhancement of their competitiveness, modernisation and technological development. Within the credit programme, in addition to the credit facility described in the section on small and medium-sized enterprises, a Regional Infrastructure and Enterprise Development Credit Programme, with HUF 15-30 billion funding, was launched to promote the reduction of regional differences, the implementation of objectives of spatial and urban catching-up, the support of enterprise zones and other regional development objectives.

4.1.5 Regulation of public utilities

165. The Act on Gas Supply, drafted taking into consideration the relevant EU directives, was approved in 2003. At present the drafting of the implementation decrees is in progress.

166. The liberalisation of the electricity market started this year, while gas market liberalisation will commence in 2004. The degree of liberalisation of the electricity and gas markets may be determined by the Government in decrees, also taking into consideration the relevant amendments of the EU directive.

167. Geological research relating to the final deposition of radioactive waste is continuing. The final deposition of low and medium activity radioactive waste can be devised after 2004, when sub-surface research works are completed.

168. In order to find a solution for the final deposition of high activity radioactive waste, a 5-year geological research programme has been launched to identify and certify the site. In line with the relevant EU directive, the research plan is geared towards examining the possibility of final deposition of high activity waste in deep geological formations. The decision concerning the site must be taken till 2008.

4.1.6 Environment protection

169. The integrating role of environment protection is on the increase. This realisation is reflected on the government level in the integration of environment and nature protection and water management into a single ministry as well as in the ongoing co-ordination on an institutional level of the activities of the high and medium level water management and environmental institutional systems.

170. The Government approved and submitted to Parliament for approval the II. National Environment Protection Programme (NEPP-II), which is co-ordinated with the National Development Plan, the 6th Environmental Action Programme of the EU and the environmental directives of the EU, and covers the period up to 2008. The Programme contains nine thematic action programmes: the Enhancement of Environment awareness action programme, the Climate Change action programme, the Environmental health and food safety action programme, the Urban environment quality action programme, the Protection of bio-diversity and landscape action programme, the Rural environment quality, area and land use action programme, the Protection and sustainable use of our waters action programme, the Waste management action programme, Environment safety action programme. The NEPP-II integrates the objectives and tasks set out in the long term Drinking Water Quality Programme, the Municipal Sewage Canalisation and Treatment Implementation Programme, the National Waste Management Plan (including the regional waste management plans) and other similar sectoral programmes, which were prepared in compliance with the EU directives.

171. The Drinking Water Reserve Protection Targeted Programme, ongoing since 1997, is proposed to be completed in 2009. The objective of the programme is to protect and safeguard the currently used and long-term drinking water reserves, to provide the basis for safe drinking water supply for the long term and to simultaneously promote the implementation of the EU Water Framework Directive.

172. The supply of drinking water through pipelines is assured practically in the whole territory of the country, but in a number of communities the quality of drinking water must be improved in line with the Community directives. In 2003, the Government defined the financing system for the implementation of the Drinking Water Quality Programme. The Programme comprises mostly the expansion or improvement of the existing supply systems.

173. The further development of the Vásárhelyi Plan, assuring the flood protection of the Tisza valley based on a new flood defence concept relying on a state-of-the-art approach, is a new task. The Plan treats as a priority the regional and rural development of the area as well as the improvement of its ecological condition, placing special emphasis on consideration of environment and nature protection at the same time.

174. The II. National Nature Protection Basic Plan is part of the National Environment Protection Programme; the Plan summarises tasks relating to the protection of biodiversity and the strategy of the protection and restoration of valuable natural assets.

175. The review and revision of the concept of the economic incentives in the environment protection system is necessary. The regulatory framework of environment protection sets out to enforce the principle of "polluter pays" and that of responsibility for

pollution through the modernisation of the existing product fee system (its transformation in line with EU requirements) and by the introduction of new product fees.

176. The fundamental principles of integrated prevention of pollution must be enforced. The public information systems describing the condition of the environment need to be improved. The spread of environment friendly products and environment management systems should be promoted.

177. In order to protect surface and sub-surface waters, the emission of "hazardous" and polluting substances, which get into the waters must be reduced, if possible at the source; furthermore, in the nitrate sensitive areas the best agricultural practice must be introduced. The implementation of the objectives of the Water Framework Directive must be assured (achievement of "good" chemical and ecological status).

4.1.7 Investment promotion system

178. The achievement of the strategic objectives of investment promotion is supported by indirect (tax-type) and direct instruments.

179. Tax-type measures include the new development tax allowance, the tax-free generation of development reserves, the tax allowance for R&D and innovation and for adult training, as well as the gradual lowering of the lump-sum health contribution.

180. In addition to EU-compatible tax allowances, the rate and intensity of direct, non-repayable grants, which are easier to forecast, has increased. The new, direct forms of assistance include the development of sites in line with investor needs; direct assistance may promote the implementation of competitive investment projects, infrastructure development, vocational training, adult training, employment, IT development, the attainment of environmental/ecological objectives, the establishment of European regional enterprise centres, the installation of strategic services, corporate research and development (R&D) and innovation. The investment promotion priority of the Economic Competitiveness Operational Programme may play an important role in all these areas.

181. Under the auspices of a service providing public administration, the mechanism of the system of support instruments has been supplemented with the institution of the confidence building document and continuously liasing with large investors.

182. In order to improve macro-economic competitiveness and taking into consideration international experiences, the Government has initiated the establishment of a Competitiveness Council (CC). In order to simplify the administrative procedures relating to the administrative licensing of (foreign) investments and to investment subsidies, conditions must be created for the introduction of a one-stop-shop subsidy award system.

4.1.8 Education, research and development

183. The policy of the Government attaches priority to the area of **education and training**. It has the objective of developing education and training in a direction which will, through the development of the human resource base of the country, strengthen the competitiveness of the economy, improve the equality of opportunities on all levels of education and reduce regional inequalities. The key components of these objectives are the following:

- development of the regulatory and institutional framework for lifelong learning,
- harmonisation of the types of training offered and the needs of the labour market, in particular in vocational training,
- development of the public education infrastructure in the regions of depressed economy,

- introduction of special education and pedagogical programmes for disadvantaged social groups in primary education and vocational training,
- modernisation of the training structure and institutional infrastructure of higher education,
- enhancement of the innovation capabilities of the business sector.

184. **Research and development** is a key instrument in strengthening economic competitiveness and human resource development. In the medium term, the Government intends to assure the increase of R&D expenditure by direct budgetary subsidies (e.g. with assistance from the National Research and Development Programme, Higher Education Research Programme), as well as by promoting successful participation in European research programmes (e.g. EU-FP 6 Framework Programme). High priorities:
- reinforcement of the research basis of universities as regional knowledge centres,
- strengthening the relationship between the private sector and academic research institutes.

4.1.9 Knowledge-based economy and information society

185. In order to reduce Hungary's lag behind advanced European countries in this field, to exploit the potential offered by info-communication technologies in enhancing economic competitiveness and improving the quality of life of people, the Government has developed strategic programmes. These programmes are presented in a uniform strategic framework (Hungarian Information Society Strategy), focusing on the following fields of action:
- In the field of infrastructure, in addition to further facilitating the acquisition of equipment by individuals, we offer access to a wide group of the public to info-communication technology in various communal formats in the short term, primarily at public access points (PIAP). The Public Net programme will assure broadband network connection to every public institution by 2006.
- Having realised the importance of IT skills, we assure, through the further development of the Sulinet (School-net) programme, that every student leaving the education system possesses state-of-the-art information technology skills. The programmes launched for active workers aim to expand user and decision maker skills. We intend to double the number of ECDL holders every year in the next three years.
- The programmes for changing negative user attitudes aim primarily to induce confidence in users. In addition, we present the potentials offered by the computer and the Internet through information dissemination programmes. We intend to assure that the rate of internet users, currently around 17%, increases to around 40% in three years.
- We attached outstanding importance to the programmes for content development within the strategy; in several instances there are implemented in co-operation between ministries, or between the public sector, the business and private sector. Programmes will be launched in the areas of the economy, health care, agriculture, transportation and employment. Under these programmes, several electronic services will be introduced.
- The research and development programmes, in addition to improving the operating conditions of the research network, strive to stimulate innovation. By strengthening links between research institutes and businesses on the one hand, and by exploiting individual initiative on the other hand, we promote the implementation of new electronic services and the maintenance of long term competitiveness.
- The programmes geared towards the equality of opportunities serve primarily to close the "digital gap", but the same programme also endeavours to assure that the average rate of use of electronic services is improved by raising at a faster-than-average rate the particularly low values measured in disadvantaged groups.

4.2 Development of the financial sector

186. In 2002, the sections of the Act on **Credit Institutions** regulating the capital requirements of co-operative credit institutions and the method of calculating the own funds of credit institutions were amended in line with the EU requirements. In 2003, new points of regulation concerning consolidated supervision were added to the Act on Credit Institutions. The directive on the reorganisation and liquidation of credit institutions was also transposed in the aforementioned Act this year. At the end of the year, the new implementing decree on consolidated adjusted capital and capital adequacy will come into force, then the entry into force of the Act regulating institutions issuing electronic money is expected in the first half of 2004. The new Basle Capital Accord to which the Hungarian regulation and supervisory activities will have to be adjusted after their adoption will entail a more extensive task.

187. As regards the **capital market**, the provisions of the EU directive on the consolidated supervision of investment undertakings and of the two new directives on the amendment of the directive on undertakings collectively investing into transferable securities (UCITS) have been transposed in 2003. The transposition of the directive on the finality of settlements was also implemented fully in 2003.

188. In respect of the regulation of the **insurance sector,** the adoption by Parliament of the new Insurance Act in June 2003 was the most important achievement in the process of legal harmonisation. The Act, besides the adoption of the provisions pertaining to membership, also applies the latest EU regulations concerning the solvency margin and intermediaries as well. Furthermore, it creates the legislative basis for the transposition of the most recent directive on motor third party liability insurance. The review of the implementing decrees to the Act is underway, in particular in the field of motor third party liability insurance.

189. The rules on the **preparation and disclosure of reports on accounts** were re-codified in 2000 and they fully comply with the relevant EU directives. The new valuation rules of the European Union, effective as of 1 January 2004, will be transposed in the Hungarian law in the second half of 2003. The authorities will take the necessary steps to assure that the new EU directive, which requires all enterprises listed on the stock exchange to prepare IAS based consolidated annual reports from 2005 onwards, is also transposed by the date of our EU accession. The implementation of the EU directive on the accounting of branches of credit institutions will also be completed before accession.

190. The Act on the **Prevention and Impeding of Money Laundering**, adopted in 2003, complies with the – amended – EU Directive on the prevention of the use of the financial system for the purpose of money laundering. In respect of the subjective scope of regulation, the new Act adopts the subjective scope extended in 2001 while containing detailed regulations concerning independent legal professions. As regards the contents of the regulation, no new requirements have been imposed; only the existing ones have been clarified. As a step in the right direction, the new Act contains clear rules as to the bodies to supervise compliance with the anti-money-laundering rules in respect of each activity, and the sanctions that can be imposed in case of non-compliance.

191. The operation of the **payment and securities settlement infrastructure** is largely in line with the requirements specified by international organisations (EMI, CPSS, IOSCO, IMF). Developments in the medium term will focus on tasks relating to EU integration and to improving the operational reliability of systems. In 2003, the adoption of EU legislation on payment systems and payment services will be completed. The NBH and the Banking Association jointly set up a Payment Systems Forum, with the purpose of co-ordinating development in the whole industry, to promote smooth accession and continued steady development. To enhance the safety of the financial intermediation system and to safeguard financial stability, both the NBH and the clearing houses

operating the settlement systems place emphasis on the design and co-ordination of their business continuity plans and the establishment of backup systems.

4.3 Employment and social policy

192. The preservation of the stability of employment, the improvement of the employment and activity rates, the alleviation of poverty and social exclusion continue to be the greatest challenges to employment and social policy. Assistance is provided by the Human Resource Development Operation Programme, transmitted to the EU this year in the framework of the NDP, which sets out the objectives, priorities and measures necessary for its implementation. The Government is preparing to design the National Employment Action Plan relying on the new European Employment Policy Guidelines as well as a joint memorandum on social integration in compliance with the common objectives of the fight against poverty and social exclusion.

193. In 2002, in order to expand employment, the amendments of the Act on the promotion of employment and on unemployment benefits aimed to improve the employability of multiple disadvantaged groups (e.g. expansion of the unemployment benefit system, the reduction by 50% of the tax burdens on employment with temporary employees' booklet, improved conditions for assistance to public work).

194. In 2003, the ratio of carrier starters has increased significantly within total unemployment figures; therefore the Government will resort to new measures to reverse this trend:

- introduction of the regular career monitoring system of school leavers to better orientate carrier selection;
- expanding the employment opportunities for full time students of higher education institutions.

195. The following measures have been taken to implement the objectives of the National Disability Programme launched within the framework of social policy:

- The investment programme "Development of obstacle free transport" has been completed.
- In the field of communication, sign language interpretation services and the training of interpreters have started.
- The review of the system of assessment of health status has started to create a uniform, state-of-the-art and international classification.
- An integrative approach has strengthened in education.
- As an important precondition of work rehabilitation, it is a fundamental provision of labour law that employees must not be discriminated against because of their disability.
- In the field of social benefits, the disability allowance has been introduced as a pecuniary benefit to persons with severe disabilities. Care in residential homes has been regulated in detail, the review of the health status of disabled persons living in long-term nursing homes has commenced, and a programme for the reform of the institutional system for disabled persons has been devised.

196. The Government programme also sets forth the development of social services and introduction of benefits which encourage and support the beneficiaries to retain their existing capabilities.

- The system of social benefits must be changed so that neighbourhood care is of primary importance, including the expansion of the system of home nursing with home assistance based on an alarm system, the establishment of a national network of special services (support service for disabled persons, organisation of community care, together with health care, for psychiatric patients and victims of addiction). It is a key principle that benefits must be flexibly adapted to needs and that care should be personalised. The Government programme also requires the improvement of social

services and the introduction of benefits encouraging the recipients to preserve their existing capabilities.
- The conditions of care in residential institutions must be modernised, continuing with the improvement of the material conditions of social institutions and investment and reconstruction programmes, which will bring about an improvement in the living conditions of the inhabitants. Both the institution management tasks and the methods of care must be modernised, introducing new procedures, therapies, development and rehabilitation sessions which comply with the requirements of our age and the relevant guidelines of the European Union.

4.4 Public sector reform

4.4.1 Health reform

197. In the past year the Government has implemented important measures planned within the reform:
- in order to increase wages in the sector and to improve the prestige of human resources, a 50% wage increase has been implemented,
- as a result of the first phase of the consolidation programme, the debt of hospitals has been reduced significantly,
- the adoption of the so-called Privatisation Act has made possible the transformation of state-owned health institutions. This improves possibilities for the involvement of external capital (professional investors, insurance companies, non-profit organisations as well as for-profit enterprises). The implementing decrees were published in mid-July, specifying in detail the procedural rules of privatisation. The Government also agreed with the Hungarian Chamber of Physicians concerning the acquisition of ownership (interest subsides) of health workers affected by privatisation.
- a monitoring system has been set up to improve the effectiveness of the prescription of pharmaceuticals. (According to plans, information relating to the use of pharmaceuticals by households will be forwarded to family doctors. In the future improved cost efficiency will be promoted by personal incentives.) As a result of the growth rate of the sale of pharmaceuticals in excess of the budgeted level, the plans to introduce free provision of pharmaceuticals for cardiac patients have been postponed.

198. From among the reform plans of the sector, the following tasks are to be implemented next year or in forthcoming years:
- on the financing side, the transformation of the contribution system, introduction of the nursing insurance,
- in respect of the self-provision of the population, the re-regulation of Voluntary Health Funds and the introduction of the personal health account,
- on the benefit side, the strengthening of the service purchasing function of the National Health Insurance Fund (OEP), the revision of the regulations aimed to improve the efficiency, service quality and its controllability, as well as the complex development programme of information technology,
- the elaboration of regional service organisation and development policy,
- the revision of the pharmaceutical subsidy system is underway, with the fundamental objective of reducing the rate of growth of the burdens on the population and on the budget while improving the standard of services.

4.4.2 Pension system

199. The objectives set out in PEP 2002 are still valid. The government aims to restore the original conditions for the two-pillar pension system introduced in 1998. On the other hand, the Government does not propose to change the fundamental conditions, that is, the roles of the pay-as-you-go first pillar and the fully funded second pillar. Still, the current deficiencies need to be redressed in case of both pillars. In the course of this,

fundamental objectives include the enforcement of the insurance principle, the enhancement of the transparency of the systems and the full implementation of tasks relating to accession to the European Union.

200. In the social security pension system, which is the first pillar, law approximation in the context of EU accession has already been completed. In the forthcoming years preparation will be accelerated for the implementation of the regulation on the co-ordination of the social security of migrant workers.

201. In the first pillar, the reinforcement of the insurance principle, i.e, increased correlation between contributions paid and benefits, remains a fundamental objective. In this context, the preference for lower benefits when awarding pensions will gradually be eliminated. Pursuant to recently adopted decisions, the level of pension benefits paid from the first pillar will increase slightly over the previously envisaged levels. The 13th month pension will be introduced gradually over four years, while survivors' benefits who receive pensions in their own right will be increased by 25% at the end of 2003. Furthermore, Parliament has instructed the Government in a resolution to consider the possibilities of further improving the situation of pensioners in the forthcoming period. In order to assure the publicity, transparency and controllability of the social security system, the Government will initiate the establishment of Supervisory Councils, operating under Parliamentary authorisation, to commence their operations on 1 January 2004. The proposed modernisation of the reporting system of pension insurance and the installation of an integrated control mechanism will promote the transparency of the pension system.

202. In the private pension fund system, the second pillar, the law approximation relating to EU accession will be completed at the end of 2003, upon the amendment of the legislation pertaining to capital investments. The rate of contribution payments into the private pension funds increased from 6% to 7% in 2003, and it will go up to 8% as of 1 January 2004. This will restore the original conditions of the pension reform.

4.4.3 Local governments

203. In line with the government programme, as indicated in PEP 2002, the review of the overall system of tasks and competences of local governments has started and is ongoing, as is the promotion of the associations of local governments to reduce the disadvantages inherent in the fragmented local government system. The establishment of the system of micro-regions and regions and the reconsideration of the financing of local governments started already in September last year. By now the programme has extended beyond local governments, to the modernisation of the entire public administration system.

204. The Government is expected to decide the directions of the reform in August 2003. The decentralisation of the tasks of government is a priority, in conjunction with the establishment of the regional administration system through governments to be elected on this level. As the first step in this direction, in 2003 the role of regional development councils in allocating funds has been strengthened, and the health reform, which is being designed, will also give an important role to the regional level.

205. In addition to the above, financial incentive to micro-regional co-operation will be an important new priority from next year on, to promote the more efficient utilisation of operating resources and that of EU and domestic development funds.

206. The reform of the regulation of the funding of local governments will continue, with the following main directions: a more efficient utilisation of resources, increased share of local revenues and that of central taxes transferred to local governments, the mitigation

of differences in the revenues of local governments, the simplification of the system of subsidies.

4.4.4 Regional development

207. The regional policy of the European Union, its objectives of strengthening social and economic cohesion, the opportunities and requirements relating to the use of the Structural and Cohesion Funds and the new national regional development accents and priorities set out in the Government programme all justify the implementation of regional development policy to be supported by a more co-ordinated participation of the government, a more efficient system of instruments and a regional and micro-regional system of institutions with adequate professional capacities.

208. The strengthening of social-economic cohesion within Hungary, the mitigation of the under-development of regions, counties and micro-regions lagging behind their more advanced counterparts and the maximum and efficient utilisation of domestic resources continue to be the key objectives of regional development. Relying on the system of direct regional development instruments supplemented by new targeted appropriations in 2003, the accelerated development of depressed micro-regions and counties will continue, the decentralised funds of ministries also placing emphasis on the acceleration of development of the most underprivileged counties and micro-regions. The Government considers these to be objectives for the whole government system, therefore it has set the objectives of co-originating resources and the harmonisation of the application objectives and procedural rules of the various systems of assistance.

209. As of 2004, the Government proposes major changes in the system of assistance in the framework of the budgeting process; the change are geared towards transforming the currently fragmented national system of subsidies into a uniform, transparent system also capable of providing co-financing to EU funds. The flexible and guaranteed co-financing of the measures of the National Development Plan and, within that, the Regional Operational Programme is a priority objective. Programmes financed from pre-accession instruments will continue; the 2002-2003 Orpheus regional PHARE programme will enter the implementation phase. It is also a requirement that the development concepts and strategic programmes of the regions are reflected in the sectoral and horizontal operational programmes as well.

210. The consistent completion of the process of regionalisation and decentralisation is a step that qualifies as a reform, along with the closely coordinated reform of the institution systems of regional development, public administration and local governmental public services in gradual, mutually interdependent steps. The Act on Regional Development will be revised within this process this year, restoring the bottom-up approach to regional development councils expressing social partnership, as recommended by the EU. The establishment of micro-regional councils as new actors in regional development is set as an objective, in close relationship with the proposed establishment of micro-regional public administration, and the expansion of the decision making powers and tasks of regional development councils.

211. The most pressing tasks in the reform of the institutional system are the creation of the still missing institutional capacities required for accession as soon as possible, the development of a planning, project identification, implementing and controlling system ensuring the complete and efficient utilisation of the EU funds, and making this system operable.

212. The Government continues to be committed to a strong regional level decentralisation, which would cover a gradually expanding range of development subsidies currently in central decision-making competence, in line with the improving professional capabilities and responsibility of the institutional system of regional

development. Having this in mind, among other factors, the Government will submit a proposal already this year for the adoption by Parliament of a resolution on a fundamentally decentralised system of regional development subsidies assuring the complete utilisation of EU funds while also safeguarding particular national interests of Hungary, covering the period up to the end of 2006. This is aimed to assure that by the programming period of the EU starting in 2007, more of the EU-financed programmes are based on the own programmes of the various regions.

4.4.5 Glass pockets programme

213. The Government programme expressly stated the objective of fighting corruption and the launching of the so-called "glass pockets" programme to this end. The primary objective of this programme is to make the finances of the government transparent and controllable, to exclude the possibility of avoiding publicity, to give incentives to the regular spending of public funds and to eliminate corruption. This system grants a central role to citizens, providing them with information and services.

214. The so-called glass pockets act approved by Parliament entered into force on 9 June 2003. The Act states as a fundamental principle that the disclosure of data relating to the use of budgetary funds and the management of public property may not be restricted by the protection of business secrecy. The Act

- regulates the relationship of the publicity of data of public relevance and of business secrets, creating the basis for the proportionate enforcement of constitutional rights;
- strengthens the role and competence of the State Audit Office, the supreme control body of the state, so that it can go beyond public entities when implementing audits, all the way through to the end user of public funds;
- renders the scope and operation of budgetary organisations more transparent, and limits their economic participation;
- defines the range of data to be disclosed related to the management of public property and public funds as well as the entities obliged to make such disclosure;
- expands the system of access to data of business enterprises in public registers as well as the publicity of Court of Registration records;
- elevates to the highest level of legislation, and simultaneously extends to the full scope of the general government, the obligation to disclose the most important data of public relevance respecting the individual, targeted subsidies from the budget and their beneficiaries;
- assures the publicity of information of public relevance relating to the use, utilisation or sale of public property and to procurement using public funds;
- regulates the rules of the internal control of state-owned companies and the provisions aimed to assure the transparency of their operation;
- provides for the transparent operation of non-profit organisation set up with public funds.

215. However, the "glass pockets programme" is not limited to the adoption of the Act; instead, it aims to establish a continuously enhanced, efficient and informative general government information system which assures primarily the disclosure of, and access to, data of public relevance. Therefore, several lower level pieces of legislation will be adopted, and administrative tasks set, under this programme already in 2003.

4.4.6 Financial control

216. In the field of financial control, the currently operating systems, institutions and methods need to be incorporated into a uniform, EU-compatible system. The internal financial control of the general governments rests on the three pillars of in-process, ex ante and ex post management control, independent internal audit, and the central harmonisation unit responsible for the co-ordination and harmonisation of the system.

217. On 16 July 2003 the Government approved, following consultation with the Budget Directorate General of the Commission, the strategy of the development of the internal financial control system of general government. Pursuant to that strategy, and taking into consideration the relevant EU regulations and the international internal control standards, a new regulation of the internal financial control system of general government is called for. The amendment of the parts of the Act on Public Finances pertaining to the internal financial control of the general government, and the drafting of new regulations relating to internal audit and the Government Control Office are in progress. By the end of the year the Minister of Finance will provide for the publication of the IIA Standards, the Code of Ethics and Charter of Internal Auditors and a number of methodological guidelines, as well as the implementation of several special training programmes for experts working in the field of auditing.

218. The control units operating in the various budgetary institutions need to be developed into functionally independent internal audit units of a consultative type, which examine effectiveness and cost-efficiency.

219. In the context of the EU Funds, a uniform control system needs to be introduced. The changing requirements relating to pre-accession funds are set out in a new government decree, while the regulation governing the financial implementation and control of assistance from the Structural Funds and the Cohesion Fund is underway.

4.5 Agriculture and rural development

220. The key strategic objectives of the development of **agriculture**, the fundamental principles of subsidies as well as the system of requirements of the proportional increase of subsidies to agricultural and rural development continue to be defined in the laws on the regulation of agriculture adopted in 1997, which, however, will need to be modified by 30 April 2004 at the latest due to EU accession and the transposition of the acquis and the subsidisation policy of the EU.

221. The acceleration of the implementation of the National Agricultural Environment Protection Programme, which relies on environment friendly land use, is on the agenda, including the creation of conditions required for receiving EU funding; furthermore, assistance to rural development programmes aimed at job creation also continues.

222. The harmonisation with the EU of the system of support to agriculture and rural development started in 2003 and will be completed in 2004. We will elaborate a recommendation on the national subsidies to be maintained after accession already in 2003.

223. Relying on the national objectives of the strategy adopted in the National Development Plan (NDP), the Agriculture and Rural Development Operational Programme (ARDOP) was prepared, which the Government approved on 30 April 2003. The ARDOP focuses primarily on improving the competitiveness of production and that of the processing sector and stabilising the ability of rural areas to retain the labour force through enhancing income-earning potentials.

224. To introduce an EU compatible product chain regulation, a new agricultural regulatory framework and a new Act on the agricultural market regime are under preparation. The new techniques of support such as intervention, export-import regulation and data and information supply obligation will be introduced gradually. In respect of cereals a new intervention system was introduced already in 2002.

225. In order to mitigate the financial difficulties faced by agricultural producers in general, debt-reducing programmes have been launched. In the first stage, a programme aiming to reduce the interest burdens on short-term loans was introduced at the end of

2002. The second stage (2003) sets out to alleviate burdens relating to long-term borrowings of farmers working in naturally less-favoured areas. The establishment of Producers' Marketing Organisations is also a priority.

226. In accordance with PEP 2002, the development of the desirable land ownership, land use and production structure continues, taking into consideration the objectives of the National Agricultural Environment Protection Programme.

227. Assuring the possibility for Hungary to maintain a favourable level of agricultural production in conjunction with the reform of the CAP continues to be one of our goals.

228. In the context of law approximation, the existing body of law has been supplemented primarily by the legislative efforts relating to veterinary health in 2002. From among the veterinary regulations, the amendment of the Act on the protection and well-being of animals and of the decree on the animal protection rules pertaining to the keeping of farm animals deserves special mention. In the field of GMO's, the amendment of the Act on gene technology activities is an important step forward. The drafting of the relating implementing decree is underway.

229. The Government has made considerable progress in establishing the organisations assuring the operation of the common market regimes. As of 1 July 2003, the Agriculture and Rural Development Office (ARDO) was set up to perform functions relating to the reception of payments from the European Agricultural Guidance and Guarantee Fund (EAGGF) and the Fisheries Orientation Financial Instrument (FOFI). This institution also performs functions of the SAPARD Agency. A Food Safety Office was also established. Quality control and the operation of veterinary and phytosanitary services at border stations have been reinforced.

230. The **rural development** objectives set forth in PEP 2002 are still effective. The use of pre-accession funds (implementation of the measures of the SAPARD programme) continues in 2003. Vocational training, development and renovation of villages, the protection and preservation of the material and cultural heritage of rural areas, the diversification of activities and the development of activities to provide alternative incomes have been added as new elements.

231. The programming document for rural development assistance is being drafted. The National Rural Development Plan (NRDP) for the measures of the Guarantee Section of the EAGGF has been completed. The NRDP is in line with several objectives of the NDP, and is closely linked with several of its Operational Programmes. Its objectives include promoting

- the spread of environment friendly production methods, thereby keeping land under cultivation,
- land use appropriate for the natural conditions of the locality by supporting farming,
- forestation,
- the conversion of semi-self-sufficient farms into farms producing for the market,
- early retirement accompanied by assistance to young farmers,
- the establishment and integration of producers' organisations and improvement of their market position,
- the improvement of the conditions of the preparation of products,
- compliance with the environmental and animal welfare requirements of the EU.

Under the auspices of the preparation for the EU LEADER programme, programmes to address specific rural social problems are ongoing with extended content and scope.

4.6 Institution development in relation with the adoption of the Acquis

232. One of the most important tasks before Hungary's EU-accession is to prepare the relevant institutions for the absorption of EU funds and to ensure the appropriate and sound financial management and control of both the Community and national funds.

- The Ministry of Finance performs the role of the Paying Authority for the Structural and Cohesion Funds. Within the Ministry of Finance the Office of the National Authorising Officer will carry out these functions and tasks. In April 2002 a functionally independent Internal Audit Department has been set up within the NAO Office, and in March 2003 the Office established its Certification Unit.
- For the EAGGF Guarantee section the Agricultural and Rural Development Office will perform the tasks of the Paying Agency.
- In the field of financial management and control and internal audit, progress can be summarised as follows:
  - In July 2002 the bodies responsible for auditing 5% (and 15% in the case of the Cohesion Fund) were designated, and the Government Control Office (GFC) became responsible for issuing the winding-up declaration. The Ministry of Finance was designated as co-ordinator of the controls and audits of Structural and Cohesion Funds, and the Inter-ministerial Committee for International Assistance Control was established headed by the Minister of Finance. The Ministry of Finance has begun elaborating the methodological guidelines for the organisations involved in the administration of the Funds.
  - The Government Decree regulating the financial management and control system of the Structural Funds will be elaborated by the end of November 2003.
  - The GCO completed the gap-assessment of the Managing Authorities, the Paying Authority and the Intermediate Bodies. The relevant action plans have been drawn up and insufficiencies are being remedied.
  - The Treasury will perform a special Intermediate Body function in the implementation of four Operational Programmes of the National Development Plan (Human Resource Development OP, Economic Competitiveness OP, OP for Regional Development, Environment Protection and Infrastructure OP).
  - By the end of 2003 Hungary will provide a sufficient audit trail on the management and control system of Structural Funds and the Cohesion Fund. The responsible body for elaborating the audit trail is the CSF Managing Authority.
  - On July 16, 2003, the Government adopted the Strategy for the development of the public internal financial control system which was also approved by DG Budget of the European Commission and sent to the other relevant DGs of the Commission.
  - On the level of Government Decrees, the re-drafting of regulations concerning internal audit is necessary (by the end of 2003).
  - The development of the framework ensuring the reliable settlement and collection of the Community's own resources is in progress.
- The appropriate evaluation system and a computerised monitoring system will be in place and fully operational by the end of 2003. (A Central Evaluation Unit has been established in the National Development Office and this office will be responsible for setting up the Community Support Framework Monitoring Committee as well. The relevant line ministries will set up the respective Operational Programme Monitoring Committees.)

233. In the framework of justice and home affairs, Hungary fulfils the requirements of the Schengen cooperation by developing human and technical conditions of our border control system. It makes possible to realise in a more sufficient way the tasks of the security policy of Hungary and those of the European Community (fight against terrorism, illegal immigration, people and drug smuggling, drug dealing). In relation to enlargement, the development of the Community's border control information system (SIS) is continuing (SIS II). At the same time, Hungary is gradually preparing for the

establishment of conditions to operate the border control information system. The Schengen Fund will provide an assistance of 147.9 million euros for the implementation. After accession to SIS II, citizens of the new member states can travel in the territory of the Community without any border control. After accession Hungary has to fully apply the visa policy of the European Community as well.

Budapest, 16 August 2003.

Implementation of Commitments in PEP 2001 Concerning Structural Reforms

Original government task	Implementation
Small- and medium-sized enterprises	
Operation of the system of the Széchenyi plan supporting small and medium-sized enterprises	Implemented.
Introduction of the Simplified Enterprise Tax to reduce administrative burdens	Implemented.
Launching of the Széchenyi Credit Card programme	Implemented.
Further development of the guarantee system	In progress.
Accession as full member to the Multi-annual Programme for Enterprise and Entrepreneurship of the EU	Implemented.
Transport	
Motorway building programme	The scheduled portions have been opened; further works are in progress.
Construction of the Duna bridge at Szekszárd	Implemented.
Railway developments	In progress.
Construction of BILK (logistics centre)	In progress.
Organisational reform of MÁV	The organisational transformation has been completed; the reform is in progress in accordance with the action plan.
Housing programme	In progress.
Governmental Development Plans	
Elaboration of the National Development Plan and its Operational Programmes	Under the control of the Office for the National Development Plan and EU Transfers established within the Prime Minister's Office, the NDP was completed by 31 March 2003, and the Operational Programmes by April 30. The documents have been transmitted to the European Commission.
Preparation of the Economic Competitiveness and Environment Protection and Infrastructure Operational Programmes	Implemented.
Consultations with the European Commission concerning the operational programmes	In progress.
In connection with the National Development Plan, and based on the experiences with the use of pre-accession funds, the creation of the institutional framework and the rules of the EU co-financed activities as regards their utilisation, control and monitoring systems.	In progress.
Regulation of public utilities	
Adoption of the Act on natural gas supply	Implemented in 2003.
Liberalisation of the energy market	Started in 2003 in respect of electricity; to commence in 2004 in respect of natural gas.

Original government task	Implementation
Environment protection	
National Waste Management Plan	Parliament adopted the National Waste Management Plan on 26 November 2002.
II. National Environment Protection Programme	The government approved the NEPP II on 4 June 2003 and provided for its submission to Parliament. Parliament is expected to approve it in its autumn session.
Vásárhelyi Plan	At its meeting of 26 February 2003, the Government approved the necessity of implementation of the Vásárhelyi Plan (Government Decree No. 1022/2003. /III. 27./) and ordered the preparation of the programme. The deadline for the preparation and submission to the Government of the programme: 30 September 2003. The preparation of Stage I of the further development of the Vásárhelyi Plan will happen in 2003, its implementation in 2004-2007.
National Drinking Water Quality Program	In 2001, the Government adopted its resolution on the tasks relating to the transposition of Directive 98/83/EC on the quality of water for human consumption. In 2003, the Government adopted the resolution on the details of the preparation and financing system of the implementation of the drinking water programme.
Knowledge-based economy and information society	
Public net programme (provision of the public sector with access to the Internet)	In progress.
National Digital Archive	In progress.
Development of the financial sector	
European passport Single authorisation Home country supervision	Implemented in December 2000 in the credit institution sector, in December 2001 in respect of investment service providers and investment funds and in June 2003 in the insurance sector in such a way that the standard text has been incorporated into the law and will take effect upon accession.
Free movement of capital in the case of insurance companies	Fully implemented by the new Insurance Act.
Health care reform	
50 % wage increase on average	Implemented.
Launching a debt reducing programme	In progress.
Creation of conditions for institutional transformation in the health sector and for equity investments	Implemented by a decision in the first half of 2003.
Expansion of the pilot managed patient care project	Implementation is continuous in accordance with the decision adopted in 2002.
Reduction of contribution payment obligations of employers (including the Health Contribution)	In accordance with the decision adopted in 2002, the level of the Health Contribution was significantly reduced in 2003. Its further reduction is proposed.

Original government task	Implementation
Pension system	
Amendment of laws related to the accession to the European Union	The overwhelming majority has been implemented
Re-institution of the mandatory pension fund membership of career starters	Implemented in 2002, entered into force as of 1 January 2003.
Increase of private pension fund contribution to 8%	Pursuant to the decision adopted in 2002, the contribution was raised from 6 % to 7% as of 1 January 2003, and will increase to 8% as of 1 January 2004.
Local government system	
Further development of the tasks and competencies of local governments	In progress in the framework of the modernisation of the public administration system. The Government will decide on the directions of further development in 2003.
Regional development	
Preparation of the Regional Operational Programme of the NDP	It has been accepted; discussion of its content will start in the second half of 2003. The programme was completed by the end of April 2003. Furthermore, by mid-July the first draft of the programme complement describing the various measures in detail was completed.
Restoration of the democratic, partnership-based character of the institutional system of regional development (amendment of the Act on Regional Development)	The proposed amendment of the Act in line with the modernisation of public administration is of "medium" depth. The draft will be submitted to Parliament in the second half of 2003.
Modernisation of the utilisation and decentralisation of regional development subsidies (submission of new parliamentary resolution)	In progress.
Comprehensive modernisation of the Act on Regional Development	Because of the "medium" depth of the amendment of 2003, the comprehensive modernisation is inopportune.
Preparation of decentralisation of regional programmes and of the institutional system to be introduced from 2007	In progress.
Agriculture and rural development	
EU-compatible amendment of the Act on the agricultural regime	Approved by Parliament.
Creation of organisations to assure the operation of common market regimes	The Agriculture and Rural Development Office (ARDO) and the Food Safety Office have been established.
Launching of debt reducing programmes	The first stage was launched in 2002, the second stage in 2003.
EU-compatible reform of agricultural regulations	Partly implemented, partly continuous implementation.
Institutional development in connection with the adoption of the acquis	
In connection with the National Development Plan, and based on the experiences with the use of pre-accession funds, the institutional framework and the rules of the EU co-financed activities as regards their planning, utilisation, control and monitoring systems must be designed.	In progress.

Government Action Plan
for the Implementation of Structural Changes and Reforms

Government task	2003	2004	2005	2006
Small and medium-sized enterprises				
Operation of the Széchenyi Enterprise Development Programme	X	X	X	X
Amendment of the SME Act	X	X		
Launch of SME financing facilities (Micro-credit, Midi-credit, Európa credit)	X			
Interest subsidies to the Midi-credit facility	X	X		
Exchange rate guarantee to the Európa credit	X	X	X	X
Interest subsidy to the Széchenyi Card	X	X		
Participation in the Multi-annual Programme for Enterprise and Entrepreneurship of the EU and in the European Charter of Small Enterprises	X	X	X	X
Preparation of SMEs for EU integration	X	X		
Transportation				
Motorway construction programme	X	X	X	X
Road surface reinforcement programme	X	X	X	X
Construction of BILK (logistics centre)	X	X		
Railway developments	X	X	X	X
Housing programme	X	X	X	X
Governmental development plans				
Discussion of Operational Programmes with the European Commission	X	X	X	X
Creation of the institutional framework and the rules of the EU co-financed activities as regards their utilisation, control and monitoring systems	X			
Regulation of public utilities				
Liberalisation of the energy market	X	X		
Environment protection				
Implementation of the National Waste Management Plan	X	X	X	X
Preparation and adoption of Regional Waste Management Plans	X			
Preparation and adoption of Local Waste Management Plans		X		
Approval of the National Water Quality Programme (financing)	X			
Approval of the further development of the Vásárhelyi Plan (flood control)	X			
Submission and approval of the II. National Environment Protection Programme	X			
Submission and approval of the II. National Nature Protection Basic Plan	X			
Investment incentive system				
Revision of the system of instruments of investment and enterprise promotion	X			

Government task	2003	2004	2005	2006
Education, research and development				
Improvement of the building stock and IT system of secondary and higher education	X	X	X	X
Knowledge-based economy and information society				
Elaboration of a new electronic broadcasting act	X			
Public net programme (provision of the public sector with access to the Internet)	X	X	X	X
Development of electronic services (eEurope, 2005)	X	X	X	X
Health care reform				
Continuous implementation of the Decade of Health government programme	X	X	X	X
Transformation of health care institutions through the involvement of private capital	X	X	X	X
Introduction of a nursing insurance system	X	X		
Development of a programme for the involvement of private capital for public purposes	X			
Introduction of the individual health account	X			
Pension system				
Increase of private pension fund contributions to 8% As a result of the change, the deficit-funding obligation of the central budget is expected to increase by HUF 19-20 billion.	X			
Amendment of legislation relating to EU accession	X			
Modernisation of the record system covering contribution payment and benefits, increased transparency of pension calculation, reinforcement of the insurance principle		X	X	X
Establishment of a Supervisory Council to supervise the social security pension system	X			
Measures to further increase the level of pension benefits (introduction of 13th month pension, increase of survivors' benefits, consideration of other measures) These measures will result in a cca. HUF 30-35 billion annual increase in expenditures in the period up to 2006.	X	X	X	X
Comprehensive review of the regulation of the private pension fund system		X	X	
Local government system				
Further development of the system of tasks and competencies of local governments – elaboration of the principles of decentralisation – amendment of the related legislation	 X X	 X	 X	 X
Further development of the system of financial regulations of local governments	X	X	X	X
Regional development				
Amendment of the Act on Regional Development	X			
Finalisation of the Regional Operational Programmes of the NDP, their discussion with the European Commission	X			
Preparation of the Programme Complement of the NDP ROP	X			
Establishment of the institutional system and procedures relating to the ROP	X			

Government task	2003	2004	2005	2006
Preparation for the monitoring of investments supported from the Structural Funds, their cost-benefit analysis and ex-ante evaluation, including the elaboration of the evaluation methodology	X			
Implementation of ex-ante and ex-post evaluation first on the central government level then on the regional level		X		
Review of the system of regional development subsidies, increasing decentralisation, review of the classification of eligible regions (submission of new parliamentary resolution)	X	X		
Reinforcement of the regional system of institutions, their preparation for the programming period starting in 2007	X	X	X	X
Review of the National Regional Development Concept		X		
Agricultural and rural development				
IIER	X	X		
Implementation of the National Rural Development Plan		X	X	X
Establishment of the remaining institutional background	X			
Transposition of the acquis and EU subsidy policy	X	X		
Elaboration of a system of subsidies that can be maintained after accession	X			
Institutional development in connection with the adoption of the acquis				
Completion of the establishment of the institutional system, and developments in the field of financial control, including establishment of administrative capacities to control the use of structural and cohesion funds and of own resources and to protect the financial interests of the Community.	X	X		

T A B L E S

Table 1. Growth and associated factors

Percentages unless otherwise indicated	ESA code	2002	2003	2004	2005	2006
1. GDP growth at constant market prices (14+15+16)	B1g	3.3	cca. 3.5	cca. 3.5	4 - 4.5	4.5 - 5
2. GDP level at current market prices, HUF billion	B1g	16980	18700-18750	20300-20400	21950-22050	23700-23800
3. GDP deflator		10.7	cca. 6.5	cca. 5	cca. 4	cca. 3
4. CPI change (annual average)		5.3	4.8 - 5	cca. 5	cca. 4	cca. 3
5. Employment growth [1]		0.1	cca. 0.5	cca. 0	cca. 1	1 - 1.5
6. Labour productivity growth [2]		3.2	cca. 3	3 - 3.5	3 - 3.5	cca. 3.5
7. Investment ratio (% of GDP)		22.3	cca. 22	22 - 23	23 - 24	24 - 25
Sources of growth: percentage changes at constant prices						
8. Private consumption expenditure	P3	10.2	9 - 9.5	cca. 2	3.5 - 4	3.5 - 4
9. Government consumption expenditure	P3	2.3	2.5 - 3	cca. -1	cca. 1	1 - 2
10. Gross fixed capital formation	P51	5.8	cca. 4	6 - 8	7 - 9	8 - 10
11. Changes in inventories and net acquisition of valuables as a % of GDP	P52+P53	1.7	cca. 1	cca. 1.5	cca. 2	cca. 2.5
12. Exports of goods and services	P6	3.8	3 - 5	6 - 8	7 - 9	8 - 10
13. Imports of goods and services	P7	6.1	5 - 7	6 - 8	8 - 10	9 - 11
Contribution to GDP growth						
14. Final domestic demand		7.2	6.5 - 7	2.5 - 3	4 - 4.5	cca. 5
15. Change in inventories and net acquisition of valuables	P52+P53	-1.9	cca. -1	0.5 - 1	0.5 - 1	0.5 - 1
16. External balance of goods and services	B11	-1.9	-(2 - 2.5)	cca. -0.5	cca. -1	cca. -1
Growth of Gross Value Added						
17. Agriculture		-8.8	-5 - 0	3 - 5	cca. 3	cca. 3
18. Industry (excluding construction)		0.4	2 - 3	cca. 3	cca. 4	4 - 5
19. Construction		14.8	3 - 4	cca. 5	5 - 6	cca. 6
20. Services		4.3	4 - 5	cca. 4	4 - 5	5 - 6

1/ Occupied population, domestic concept, persons, national accounts definition

2/ Growth of GDP at market prices per person employed at constant prices

Table 2. Labour markets developments

Percentages unless otherwise indicated	2002	2003	2004	2005	2006
1. Population (thousands)	10160	10120	10100	10080	10060
2. Population (growth rate)	-0.3	-0.4	-0.2	-0.2	-0.2
3. Working age population (thousands) [1]	6850	cca. 6840	cca. 6830	cca. 6820	cca. 6810
4. Participation rate [1]	59.7	cca. 60	60 - 60.5	cca. 61	61 - 62
5. Employment level (thousands) [1]	3850	cca. 3870	cca. 3870	cca. 3910	cca. 3955
6. Employment (growth rate) [1]	0.2	cca. 0.5	cca. 0	cca. 1	1 -1.5
7. Public sector empl. (thousands)	800	cca. 820	cca. 800	cca. 800	cca. 800
8. Public sector empl. (growth rate)	1.5	cca. 2.5	-(1 - 3)	cca. 0	cca. 0
9. Unemployment rate (ILO definition)	5.8	5.8 - 6	5.8 - 6	5.5 - 6	5.5 - 6
10. Average real wage (growth rate)	13.6	10 - 12	cca. 0	1 - 2	2 - 3

[1/] 15 to 64 years-old.

Table 3. External sector developments

Euro bill. unless otherwise indicated	2002	2003	2004	2005	2006
1. Current account balance (% of GDP)	-4.0	-(5 - 5.5)	cca. -5	cca. -5	cca. -5
2. Export of goods	36.8	36.7 - 37	39 - 40	43 - 43.5	47.5 - 48.5
3. Import of goods	39.0	cca. 40	42.5 - 43	cca. 47	52 - 53
4. Trade balance	-2.2	-(3 - 3.3)	-(3.1 - 3.4)	-(3.5 - 4)	cca. -4.5
5. Export of services	8.2	8.3 - 8.6	9.2 - 9.6	10.3 - 10.8	11.5 - 12
6. Import of services	7.6	8 - 8.3	8.8 - 9.2	9.8 - 10.3	10.8 - 11.3
7. Service balance	0.6	0.3 - 0.4	0.4 - 0.5	0.5 - 0.6	cca. 0.7
8. Net interest payments from abroad	-0.7	-(0.8 - 0.9)	cca. -0.9	-(0.9 - 1)	cca. -1
9.Other net factor income from abroad [1]	-1.0	cca. -1	-(1 - 1.1)	-(1 - 1.1)	-(1 - 1.2)
10. Current transfers	0.5	0.5 - 0.6	0.6 - 0.8	0.9 - 1.1	1.1 - 1.3
11. Of which from EU	0.2	cca. 0.2	0.3 - 0.4	0.5 - 0.6	cca. 0.7
12. Current account balance	-2.8	cca. -4	cca. -4	-(4 - 4.5)	-(4.5 - 5)
13. Foreign direct investment [2]	0.9	0.9 - 1.1	1.3 - 1.5	1.6 - 1.8	cca. 2
14. Foreign reserves	9.9	cca. 10	cca. 10	cca. 10	cca. 10
15. Foreign debt [3]	32.4	35 - 36	cca. 38	39 - 40	cca. 41
16. Of which: public	18.4	20 - 21	22 - 22.5	23 - 23.5	24 - 24.5
17. Of which: foreign currency denominated	10.8	cca. 11	10 - 10.5	cca. 9	cca. 8
18. Of which: repayments due	0.9	2.6	1.1	1.7	0.8
19.Exchange rate vis-á-vis EUR (end-year)	235.9	255	255	255	255
20. Exchange rate vis-á-vis EUR (annual average)	243	253.5	255	255	255
21. Net foreign saving (lines 21-25: percentages of GDP)	-3.8	-(5 - 5.5)	-(4.5 - 5)	-(4.5 - 5)	-(4.5 - 5)
22. Domestic private saving [4]	23.2	18.5 - 19	cca. 19.5	19.5 - 20	cca. 20.5
23. Domestic private investment	17.8	19 -19.5	20 - 20.5	21.5 - 22	cca. 23
24. Domestic public saving [4]	-3.0	cca. -1.5	cca. 0	cca. 1	cca. 1.5
25.Domestic public investment	6.2	3 - 3.5	3.5 - 4	3.5 - 4	cca. 4

[1/] Profittransfer and compensation of employees
[2/] With intercompnay loans and without reinvestments
[3/] Without intercompany loans
[4/] Including capital transfer

Table 4. General government budgetary developments

Percentages of GDP	ESA code	2002	2003	2004	2005	2006
Net lending (B9) by sub-sectors						
1. General government	S13	-9.2	-4.8	-3.8	-2.8	-2.5
2. Central government	S1311	-8.0	-3.3	-2.1	-1.0	-0.4
3. State government	S1312	-	-	-	-	-
4. Local government	S1313	-0.7	0.0	-0.1	-0.1	-0.3
5. Social security funds	S1314	-0.5	-1.5	-1.6	-1.6	-1.8
General government (S13)						
6. Total receipts	ESA	44.5	43.2	44.4	44.2	43.6
7. Total expenditures	ESA	53.7	48.0	48.2	47.0	46.1
8. Budget balance	B9	-9.2	-4.8	-3.8	-2.8	-2.5
9. Interest	D41	-3.7	-3.6	-3.4	-3.2	-2.9
10. Primary balance		-5.5	-1.2	-0.4	0.4	0.4
Components of revenues						
11. Taxes	D2+D5	25.4	25.9	27.1	27.1	26.9
12. Social contributions	D61	12.9	12.7	12.9	12.5	12.2
13. Other		6.2	4.6	4.4	4.6	4.5
14. Total receipts	ESA	44.5	43.2	44.4	44.2	43.6
Components of expenditures						
15. Collective consumption	P32	7.5	7.8	7.7	7.6	7.4
16. Social benefits in kind	P31	10.4	11.4	11.1	10.8	10.5
17.Social transfers other than in kind	D62	13.3	13.5	13.2	13.0	12.8
18. Interest	D41	4.0	4.0	3.5	3.3	3.1
19. Subsidies	D3	2.5	2.7	2.7	2.7	2.7
20. Gross fixed capital formation	P51	6.2	3.4	3.9	3.9	4.1
21. Other		9.8	5.2	6.1	5.7	5.5
22. Total expenditures	ESA	53.7	48.0	48.2	47.0	46.1

Table 5. General government debt developments

Percentages of GDP	ESA code	**2001**	**2002**	**2003**	**2004**	**2005**
1. Gross debt level		56.3	57.5	57.2	55.3	54.0
2. *Of which* : repayments due		23.5	29.1	22.7	22.2	22.7
3. Change in gross debt		9.6	6.4	4.3	2.5	2.7
Contributions to change in gross debt						
4. Change in debt ratio (% points)		2.9	1.2	-0.3	-1.9	-1.3
5. Primary balance	B9	5.5	1.2	0.4	-0.4	-0.4
6. Interest	D41	3.7	3.6	3.4	3.2	2.9
7. Nominal GDP growth	B1g	-6.7	-5.2	-4.6	-4.4	-4.0
8. Other factors influencing the debt ratio		0.4	1.6	0.5	-0.3	0.2
9. *Of which* : Exchange rate change		-0.6	1.0	0.0	0.0	0.0
10. *Of which* : Privatisation receipts		0.0	-0.6	-0.5	-0.5	-0.2
11. *p.m.* implicit interest rate on debt (%)		8.5	7.0	6.5	6.2	5.8

Table 6. Divergence from previous update

	2002	2003	2004	2005	2006
1. GDP growth (% points)					
Previous update	cca. 4	4 - 4.5	4.5 - 5	5 - 5.5	-
Latest update	3.3	cca. 3.5	cca. 3.5	4 - 4.5	4.5 - 5
2. Current account deficit (Euro billion)					
Previous update	2.4 - 2.6	2.4 - 2.6	2.5 - 2.8	2.7 - 3	-
Latest update	2.8	cca. 4	cca. 4	4 - 4.5	4.5 - 5
3. Gross foreign debt levels (Euro billion)					
Previous update	31.5 - 32	cca. 32	32 - 32.5	cca. 33	-
Latest update	32.4	35 - 36	cca. 38	39 - 40	cca. 41
4. General government deficit (% of GDP)					
Previous update [1]	5.5 - 6	cca. 4.5	cca. 3	cca. 2.5	-
Latest update [1]	9.2	cca. 4.8	cca. 3.8	cca. 2.8	cca. 2.5
5. Gross public debt levels (% of GDP)					
Previous update [1]	cca. 53	52 - 53	51 - 52	cca. 50	-
Latest update [1]	56.3	cca. 57.5	57 - 57.5	55 - 55.5	cca. 54

[1/] ESA 95 definition

Table 7. Assumption on the external economic environment underlying the 2002 PEP framework

Variable (annual growth rates in %, If not otherwise stated)	Assumptions for				
	2002	2003	2004	2005	2006
Interest rates (in % p.a., annual averages)					
- Hungary: short-term	8.9	7.1	7.0	6.0	5.5
- Hungary: long-term	7.1	6.4	6.0	5.7	5.5
- Euro area: short-term (3-months money markets)	3.3	2.3	2.3	-	-
- Euro area: long-term (10-year govt bonds, lowest one prevailing in euro area)	4.9	4.3	4.4	5.6	5.6
- USA: short-term (3-months money markets)	1.8	1.4	3.0	-	-
- USA: long-term (10-year govt bonds)	4.6	4.1	5.0	5.8	5.8
GDP (in real terms)					
- World, excluding EU	3.0	3.2	4.1	4.4	4.4
- USA	2.4	2.5	4.0	3.5	3.5
- Japan	0.3	1.0	1.1	1.7	1.7
- EU 15	1.0	1.2	2.4	2.4	2.4
World trade (in real terms)					
Hungarian export markets	0.2	4.2	6.9	7.0	7.0
World imports	2.9	4.3	6.1	6.7	6.7
International prices					
World import prices (goods, in USD)	3.1	8.2	1.1	1.0	1.0
Oil Prices (Brent - USD per barrel)	24.1	26.0	25.0	24.5	24.0
Non-oil commodity prices (USD)	3.8	9.4	2.3	1.1	1.1

Table 8. Cyclical developments

Percentage of GDP	ESA kód	2002	2003	2004	2005	2006
1. GDP growth at constant prices	B1g	3.3	3.5	3.5	4.2	4.7
2. Actual balance	B9	-9.2	-4.8	-3.8	-2.8	-2.5
3. Net interest payments	D41	-3.7	-3.6	-3.4	-3.2	-2.9
4. Potential GDP growth		4.0	4.0	4.0	4.0	4.0
5. Output gap		-0.4	-0.8	-1.2	-1.1	-0.4
6. Cyclical budgetary balance		-0.1	-0.2	-0.4	-0.3	-0.1
7. Cyclically-adjusted balance (2-6)		-9.1	-4.6	-3.4	-2.5	-2.4
8. Cyclically-adjusted primary balance (7-3)		-5.4	-1.0	0.0	0.7	0.5